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The Oil & Gas and ADR: A Marriage Made in Heaven Waiting to Happen

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TULSA LAW JOURNAL

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THE OIL & GAS LEASE AND ADR: A MARRIAGE MADE IN HEAVEN WAITING TO HAPPEN

Joseph Shade†

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I. INTRODUCTION

The main question explored by this paper is why and how alternate dispute resolution (“ADR”) can be utilized effectively to resolve disputes between lessors and lessees which arise under an oil and gas lease. The answer requires a basic understanding of both the oil and gas lease and ADR.

Pursuant to an oil and gas lease, the central document to oil and gas exploration and development, a person who owns land¹ which an oil company desires to develop for oil and gas leases that land to the oil company. The landowner, as lessor, authorizes the oil company, as lessee, to conduct operations on the landowner’s land at the oil company’s sole risk and expense. In return, the landowner receives certain consideration consisting primarily of a bonus and royalty.²

The oil and gas lease creates a relationship between the lessor and lessee which may last for generations.³ The long term expectations of both the lessor and lessee are the same—the expectation of profit from oil and gas production. The business deal, evidenced by the oil and gas lease, is structured so that if a good well or wells are developed on the leased property both the lessor and lessee will profit. However, the intermediate interests and goals of the lessor and lessee tend to be quite different. Thus, disputes between lessees and lessors often arise. Such disputes are often resolved through litigation, which is costly, time consuming, and often harmful to the long term relationship between lessors and lessees.

1. This paper assumes that the landowner owns both the surface and the minerals underlying his land. This is not always the case since mineral ownership can be severed from surface ownership. EUGENE O. KUNTZ ET AL., *CASES AND MATERIALS ON THE LAW OF OIL AND GAS* 11-15 (2d ed. 1993).

2. See *infra* part II.A, particularly note 16. The amount of the royalty and bonus are matters negotiated between the lessor and lessee. The amount of each may vary widely depending on the desirability of the land in question as a prospect for oil and gas development.

3. On the other hand, the relationship may last a relatively short time. The modern oil and gas lease may terminate on its first anniversary date if the lessee fails to pay delay rentals or it may last as long as there is production in “paying quantities” from the property covered by the lease. See *infra* part II.B.2.a.

ADR is the use of a neutral third party to facilitate resolution of disputes outside of a formal court of law.⁴ This broad definition includes a wide range of procedures which can be used separately or in various combinations. The principal distinguishing factor among the various ADR procedures is whether the neutral third party has the power to impose a solution on the disputants or merely assists the disputants in arriving at their own solution. Procedures in which solutions are imposed are called adjudicative procedures.⁵ The prime example is arbitration. Procedures in which the parties, assisted by the neutral third party, work out their own solutions are called consensual procedures.⁶ The prime example is mediation. There are also a number of hybrid procedures which combine elements of both arbitration and mediation.⁷

The broad-based advocacy over the past two decades for increased use of arbitration, mediation, and other ADR procedures in resolving disputes is often called the alternative dispute resolution movement. It is a movement based primarily on practical rather than philosophical considerations. Today's legal system is burdened by an overly litigious society and by a proliferation of laws designed to regulate business, ensure civil rights, and protect consumers. The result has been a litigation explosion which has clogged our courts and caused many experts to suggest alternatives to litigation.⁸

Although various forms of alternate dispute resolution have been used for centuries, with the exception of traditional arbitration long used in certain industries such as securities and traditional mediation of labor disputes, ADR was not extensively used as a tool for resolving business disputes until the early 1980s.⁹ Today, however, ADR is widely used in resolving business disputes and has as much general support as any process in our legal system.¹⁰

4. HANDBOOK OF ALTERNATE DISPUTE RESOLUTION 28 (Amy L. Greenspan ed., 2d ed. 1990) [hereinafter TEXAS ADR HANDBOOK].

5. CENTER FOR PUBLIC RESOURCES, MODEL ADR PROCEDURES IN TECHNOLOGY DISPUTES 7 (1993) [hereinafter CPR-TECHNOLOGY DISPUTES].

6. *Id.* at 2.

7. *See infra* part III.C.

8. More than 15 million lawsuits are filed every year in the United States. Between 1964 and 1984 the per capita rate at which law suits were filed tripled. *See* PETER LOVENHEIM, *MEDIATE, DON'T LITIGATE* 3 (1989).

9. SUSAN M. LEESON & BRYAN M. JOHNSTON, *ENDING IT: DISPUTE RESOLUTION IN AMERICA* 47-49, 134-35 (1988) (providing a short background of arbitration and mediation respectively).

10. CENTER FOR PUBLIC RESOURCES, *MEDIATION OF BUSINESS DISPUTES* (1991) [hereinafter CPR-BUSINESS DISPUTES].

Why has ADR become so popular? Quite simply, because it works. As former Chief Justice Warren E. Burger put it, lawyers would recommend litigation less frequently if they remembered that "[p]eople with problems, like people with pains, want relief, and they want it as quickly and inexpensively as possible."¹¹ ADR is often the least costly, most expeditious, and most effective way of resolving disputes. In disputes arising under an oil and gas lease it can be more than that. It is often the best means of preserving existing relationships, fashioning appropriate forward looking remedies, and giving the parties maximum control over the resolution of their disputes.

Despite the strong momentum of the ADR movement and the suitability of ADR procedures for resolving disputes between lessors and lessees,¹² the oil and gas industry has been slow to embrace ADR as a means of resolving disputes.¹³ In the near future, both oil companies and landowners will come to view ADR and the oil and gas lease as a marriage made in heaven. Lease forms will be amended to include a compulsory ADR clause and ADR will become an everyday part of the oil and gas business.

II. THE OIL & GAS LEASE

To understand how ADR procedures can be employed effectively to resolve disputes between parties to an oil and gas lease, one must understand certain basics regarding the oil and gas lease and the relationships and expectations it creates.

A. *The Basic Nature of the Oil & Gas Lease*

The oil and gas lease is not a lease in the traditional landlord/tenant sense.¹⁴ Rather it is a legal instrument which documents a unique business transaction and creates a unique set of relationships. The oil and gas lease has been described as follows:

11. Warren E. Burger, *Our Vicious Legal Spiral*, 16 JUDGES J. 22, 49 (1977).

12. See *infra* part IV. See also CENTER FOR PUBLIC RESOURCES, ADR FOR OIL AND GAS INDUSTRY DISPUTES (1991) [hereinafter CPR-OIL AND GAS].

13. This is not to suggest that oil companies do not use ADR. Arbitration is extensively used in international operations. Many contracts made by oil companies have ADR clauses and parties to a lease or contract often willingly submit to mediation or arbitration after litigation is instituted. While anecdotal evidence abounds as to the non-use of ADR to resolve disputes between lessors and lessees arising under domestic oil and gas leases, to this writer's knowledge no empirical studies on this point currently exist.

14. Oil and gas leases differ from ordinary real property leases in that the lessee: (1) has the right to use the land and to take substances of value from it; (2) is not limited to a specific term of years; and (3) must share usage rights with the surface owner. JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 171-72 (2d ed. 1988).

[The oil and gas lease is] both a conveyance and a contract. . . . A conveyance because it is the instrument under which the mineral owner conveys a right to an oil company to explore for and produce oil and gas. . . . A contract because the oil company accepts the right to explore and produce burdened by certain express and implied promises.

* * * * *

The key to understanding the oil and gas lease is to remember that it's a business transaction. A mineral owner, who generally lacks the capital or expertise to explore or develop, transfers those rights to an oil company (reserving a royalty interest in production). Both parties expect to make a profit from the transaction and the lease sets out their bargain.¹⁵

In other words, pursuant to the oil and gas lease, a person who owns land ("landowner") leases his or her land to an oil company, which has the capital and technology to develop the land for oil and gas. The landowner, as lessor, authorizes the oil company, as lessee, to conduct operations on his land at the oil company's sole risk and expense. In return, the landowner typically receives an initial cash payment on signing the lease, called a bonus, and a share of production in any oil and gas produced from his land, called a royalty.¹⁶

1. The Interests Created by the Oil & Gas Lease

The oil and gas lease is both a conveyance of property rights from the lessor to the lessee and an executory contract between such parties.¹⁷ The lessee's interest in the mineral estate is commonly called the working interest.¹⁸ The working interest lasts as long as the lease lasts. In other words, as long as the lease is in effect the lessee has an exclusive right to explore for and develop oil and gas on the property subject to the lease. In addition to his/her surface rights and payments

15. KUNTZ, *supra* note 1, at 138-39.

16. Royalty can be defined as a share of oil and gas produced from the land, free from the cost of production. LOWE, *supra* note 14, at 44. Royalty is often used as a means of compensation in ventures in which value is highly speculative. In addition to oil and gas ventures royalties are often used in media or publishing ventures. Another type of payment sometimes received by the lessor is delay rentals. A delay rental is a sum of money paid by the lessee to the lessor for the privilege of deferring the commencement of drilling operations during the primary term of the lease. See HOWARD R. WILLIAMS & CHARLES J. MEYERS, *MANUAL OF OIL AND GAS TERMS* 299 (8th ed. 1991).

17. LOUIS G. MOSBURG, JR., *LANDMAN'S HANDBOOK ON BASIC LAND MANAGEMENT* §§ 3.02(a), 3.04(a) (1978).

18. WILLIAMS & MEYERS, *supra* note 16, at 1377. Such interest is also sometimes called the leasehold interest or the operating interest. All mean essentially the same thing.

or rights to payment received in consideration for executing the lease, the lessor retains a right of reversion in the mineral estate.¹⁹

2. The Underlying Business Deal

Exploration and production of oil and gas require the combination of three basic elements—land, capital, and technology. The oil company presumably has the capital and technology. The landowner has the land, which is the “raw material” that oil companies need for oil and gas development. The oil company does not want the expense of owning the land. It does, however, want to control the land for purposes of oil and gas exploration and development.

Under the oil and gas lease, the oil company is given the right to develop the land for oil and gas at its sole risk and expense. In return, the landowner or lessor receives money up front, in the form of a bonus, and the expectation of more money later, in the form of royalty. In other words, the lessor contributes the land and gives the lessee the operating rights. The lessee contributes the financial resources and technical know-how and assumes all of the operating risks and duties.

3. The Basic Expectations of the Lessor and Lessee

The long term expectations of both the lessor and lessee are the same—profit from production. The deal is structured so that both the lessee and the lessor will make money from production if one or more good wells are developed on the property. But their intermediate goals and expectations are quite different. The lessee wants exploration rights on the land for as long a period of time as possible. The lessee wants an option but not the obligation to drill. If production is obtained the lessee wants to hold the lease for as long as it is profitable to do so. The lessee also wants the rights to use the surface for exploration to be as broad as possible and to pay as little as possible for these rights. Obviously, the short term interests of the lessor, who is basically seeking maximum royalty income and minimum interference with the use of the surface, might conflict with those of the

19. The incidents of mineral ownership are well established and consist of the following: (1) The development right, which includes the right to explore for and develop minerals as well as the obligation to pay any costs of exploration and development. The development right also includes the right to reasonable use of the surface and the right of ingress and egress, (2) The executive right, which is the power to lease, and (3) The right to economic benefits under the lease, usually bonus, delay rentals and royalties. See *Altman v. Blake*, 712 S.W.2d 117 (Tex. 1986). See also Bruce M. Kramer, *Conveying Mineral Interests—Mastering the Problem Areas*, 26 TULSA L.J. 175 (1990).

lessee. Thus a significant number of disputes occur between lessors and lessees.²⁰

B. *History and Evolution of the Modern Oil & Gas Lease*

1. In General

The oil and gas lease was developed as a special instrument to meet the needs of both landowners and oil companies. The modern form of the oil and gas lease evolved by trial and error over many years. While there is no such thing as a "standard" form of lease, various printed forms are frequently used. Exhibit A is a form of lease frequently used in Texas,²¹ which will be referred to, herein, as the "typical" modern form of oil and gas lease to provide a framework for reference and discussion.

The lease document evolved into its present form in response to the needs of both the landowner and the oilman. Early oil and gas leases were short and most were influenced by salt leases and hard mineral leases prevalent at the time.²² An example of one of the earliest known leases is shown in Exhibit B. This is the lease covering the property on which Col. Edwin Drake drilled the first oil well near Titusville, Pennsylvania.²³ The entire lease consisted of a single paragraph. It was for a term of 15 years but contained a right to renew. The sole consideration under the lease was called rent but was really royalty, 1/8 of the oil produced.²⁴ Finally, the lease mandated that a well be drilled as early in the spring season as weather would permit. An obligation to drill was typical in early leases, because it was thought at the time that oil was "fugacious"—constantly on the move like an underground river or a wild animal. The idea was to capture the oil before it moved on to adjoining land. Under the old lease form, shown in Exhibit B, breach of the obligation to drill resulted in forfeiture of the lease. Gradually, the oil and gas lease evolved into its modern form.

20. See *infra* part VI.

21. The annotated lease form attached as Exhibit A is a slightly altered version of AAPL Form 675, Texas Form of Oil and Gas Lease. It is probably the form most frequently used in Texas. Other parts of the country such as Oklahoma, the Appalachian region, the Rocky Mountain region and California use slightly different lease forms and, of course, the parties are free to create their own forms in any given transaction. Current differences in the various lease forms do not materially impact on the use of ADR to resolve disputes between lessors and lessees.

22. MOSBURG, *supra* note 17, §§ 1.10, 3.02(b).

23. Col. Drake's well was drilled in 1859 and oil was discovered at a depth of 69 feet.

24. This royalty was payable in kind, but the lease specified that the royalty oil could be purchased at 45 cents per gallon. See *supra* note 16 for a definition of royalty.

2. Some Examples of Evolution

a. *The Modern Habendum Clause and Timeline*

As more became known about the scientific nature of oil and gas, it was realized that the clause which mandated immediate drilling to capture the oil and gas before it escaped was unnecessary.²⁵ Once this became known, the parties began tailoring leases for future rather than immediate development. Early lease forms did not provide for cash bonuses or delay rentals. Nor did they contain a “thereafter clause” to keep the lease in force after the end of the primary term. However, when the focus changed from immediate to future development, these provisions became necessary and desirable. The lease forms evolved accordingly. The eventual result was the modern habendum (§2 of Exhibit A) and the drilling and delay rental clauses (§5). The net effect of these clauses was to create the timeline we know today, which divides the term of the lease into two segments called the primary term and the secondary term.

The Primary Term (P/T) is for a fixed number of years—three, five or whatever number of years is negotiated. During the P/T the lessee has the option but not the obligation to drill. However, under the drilling and delay rental clause, the lessee must either drill or pay delay rentals on or before the anniversary date of the lease.

The Secondary Term (S/T), created by the thereafter clause in the habendum clause, lasts as long as oil and gas is produced in paying quantities from the property covered by the lease.²⁶

The timeline established by the P/T and S/T reflects the underlying business deal. It gives the lessee the option but not the obligation to explore during the P/T. If production is attained it gives the lessee

25. Today we know there are no underground rivers of oil. It exists in pore spaces of certain rock formations and remains relatively stable until the reservoir rock is penetrated with a drill bit. Then, due to pressure from water or gas, it tends to migrate toward the opening.

26. Modern lease forms only use the term “produced.” However, in recognition that the underlying economic purpose of the oil and gas lease is to produce oil and gas profitably and that when this can no longer be done, the lease should terminate, the courts developed the paying quantities doctrine. Paying quantities is defined through a two-prong test. First, operating revenues must exceed operating costs, without regard to recovery of drilling costs. If the first prong is met, the second may be considered, i.e., whether a reasonable prudent operator, seeking to make a profit, and not merely holding for speculation, would continue to operate under the circumstances. This is judicial gloss developed by the Texas courts and now followed in the great majority of states. See *Clifton v. Koontz*, 325 S.W.2d 684, 691 (Tex. 1959); *Garcia v. King*, 164 S.W.2d 509, 511-12 (Tex. 1942); see also *Henry v. Clay*, 274 P.2d 545, 548 (Okla. 1954); *Gypsy Oil Co. v. Marsh*, 248 P. 329, 334 (Okla. 1926); *infra* part VI.B.2.

the right to hold the lease as long as it is economically viable to do so.²⁷

b. Savings Clauses

Under early lease forms, which were in common use at least through the 1920s, production was needed at the end of the P/T to propel the lease into the S/T. In other words, the lessee had to drill and establish production prior to the end of the P/T and then had to maintain production in order to hold the lease during the S/T. Thus, leases were sometimes terminated in situations where termination was arguably unfair, as illustrated by *Baldwin v. Blue Stem Oil Co.*²⁸

In *Baldwin*, the form of lease that governed called for production and had no savings clauses.²⁹ The lessee was in the process of drilling a well when the P/T ended, but was unable to complete the well and obtain production before the end of the P/T.³⁰ An incredible series of mishaps delayed completion.³¹ First, it did not rain enough, then it rained too much.³² There was also mud, a blizzard, and World War I, which caused a scarcity of materials.³³ The court read the lease and said production, not excuses, is needed to hold the lease during the secondary term.³⁴

The evolutionary response was to amend the lease form to require commencement of operations for drilling, rather than production, prior to the expiration of the P/T. Further, over time, savings clauses were added to the lease form to cover situations where it made sense and was equitable to extend the lease temporarily in the absence of actual production. The most important of the savings clauses are: 1) Dry hole, cessation of production and operations clause;³⁵ 2) Shut-

27. A modern oil and gas lease might be in effect for as short a time as one year (i.e. until the first delay rental payment is due) or it might last for generations (i.e. so long as there is production in paying quantities from the land).

28. 189 P. 920 (Kan. 1920).

29. *Id.* at 921.

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.* at 922.

35. See *infra* part II.B.2.c.

in royalty clause;³⁶ and 3) Force majeure clause.³⁷ These savings clauses all operate as substitutes for production and will hold the lease for a time if the lessee works diligently and in good faith to remedy the situation which caused the delay or cessation of production.

c. *The Operations Clause*

Paragraph 6 of Exhibit A, the dry hole, operations and cessation of production clause ("operations clause"), is the most complex of the savings clauses. This clause has been modified and refined over the years in response to three common events which delayed production, sometimes causing lessees to lose leases prior to the advent of the modern operations clause.

One part of the clause deals with cessation of production. If the well ceases producing, the lessee can nevertheless keep the lease alive if, within the time period stated in the lease (i.e. 60 days), the lessee commences repairs. The lessee does not have to get the well producing within 60 days; he just has to start working on the problem in good faith within the time period provided, and continue such work with due diligence until production is restored.

The operations part of the clause deals with the situation encountered in *Baldwin v. Blue Stem Oil Co.*,³⁸ where at the end of the P/T operations were in progress but actual production had not yet commenced.³⁹ The operations portion of the operations clause now specifies that the lease will not expire if operations are commenced prior to the expiration of the P/T and continued to completion, with no cessation of operations for more than 60 consecutive days (or whatever time period is stated in the lease). In other words, it allows the lessee to finish what he has begun if he acts with due diligence.⁴⁰

36. This is a critical clause which operates to hold a lease when the lessee completes a well capable of producing natural gas but is unable to market the gas because there is no pipeline to transport the gas to buyers. Under the shut-in gas royalty clause the lessee can hold the lease by making the shut-in royalty payments required under the lease so long as he diligently and in good faith is trying to find a market and has a reasonable probability of doing so.

37. The force majeure clause operates to save an oil and gas lease when the lessee is prevented from performing (or performance is delayed) because of conditions specifically stated in the clause. Noting the variance in the way force majeure clauses are written, Eugene Kuntz summarizes the analytical problems encountered with such clauses as follows: "[A]pplication of the clause can involve three separate questions: (1) is the obligation or performance covered by the clause, (2) is the event which prevented performance described in the clause, and (3) did the event effectively prevent performance. . .?" KUNTZ, *supra* note 1, at 239.

38. 189 P. 920 (Kan. 1920).

39. *Id.* at 921.

40. Under a clause worded slightly differently from the clause in Exhibit A (i.e. "so long as operations are. . ."), the Texas Supreme Court construed the word operations very narrowly,

The dry hole part of the clause covers a situation where the lessee, while the lease is in effect, drills a dry hole but desires to drill a second well before the lease expires.⁴¹ Exhibit A, and most modern lease forms, contains a savings clause which provides that if the lessee drills a dry hole, he can keep the lease alive by starting to drill another well on the leased property within a stated period of time (i.e. 60 days).

The purpose of the operations clause is to maintain the lease in the event of temporary delays or interruptions of production as typified by the events described above, all of which are events that lessees may experience. The operations clause was developed to guard against such contingencies. In modern lease forms, all three contingencies are interwoven into a single clause which allows the lessee to maintain the lease by some sort of operations, rather than production.

d. The Pooling and Pugh Clauses

Our final example in this short look at the evolution of the oil and gas lease concerns the pooling and Pugh clauses. A pooling clause allows the lessee to combine acreage from two or more leases together to form spacing units. In addition, lease pooling clauses generally provide that operations for drilling or production on any acreage within the unit will be considered operations or production from the leases pooled. This modifies the Habendum Clause in favor of the lessee. It also contains provisions for apportioning royalty on the basis of the surface acres from the respective leases contained in the unit, which modifies the royalty clause. Lessees consider pooling clauses highly desirable since such clauses give the lessee the option of exercising the pooling authority delegated to him by this clause, but does not require him to do so. Absent a pooling clause in the lease, the lessee has to get the lessor's permission to pool. This gives the lessor the power to either deny permission to pool or charge handsomely for granting

holding that the wording of the clause in question permitted the lessee only to complete drilling of the well started prior to the end of the primary term but not to commence drilling a second well. *Rogers v. Osborn*, 261 S.W.2d 311, 314-15 (Tex. 1953). The type of clause involved in *Rogers*, which today is no longer in vogue, is called a well completion clause. In response to that holding, the clause was slightly modified to read as set forth in Exhibit A. As modified, the clause now permits a lessee to commence a well before the end of the primary term, abandon it after the end of the primary term, and continue to hold the lease by starting another well within 60 days. This version of the clause is called a continuous operations clause. See also *LOWE*, *supra* note 14, at 237-40.

41. For example, the lessee obtains information from the drill core indicating that if he moves the location 100 feet to the west, he may encounter a producing formation.

such permission. Thus, for obvious reasons, a pooling clause is a valuable clause for the lessee.

For equally obvious reasons, lessors sometimes resisted signing leases with pooling clauses. To avoid an "either-or" situation, a negotiated compromise was reached in the form of the so called Pugh clause. This clause is a lease modification which benefits the lessor. The clause was named for Lawrence Pugh, a Louisiana lawyer who is credited with inventing the clause. The effect of the Pugh clause is to partially negate the pooling clause. The Pugh clause modifies the usual pooling language to provide that operations or production from a pooled unit will not hold the whole lease, but rather will only maintain the lease as to that part of the lease acreage which is actually in the producing unit. This is a valuable clause for the lessor. The larger his tract, the more important it is for the lessor to have a Pugh clause. Today, Pugh clauses appear in a large percentage of modern leases. They are another example of the evolution of the lease to meet the needs of the parties.

C. *Current Structure of the Modern Oil & Gas Lease*

Over time, numerous judicial decisions, trial and error, drafting and negotiations caused an evolution in the typical lease form from what we began with (Exhibit B) to what we have today (Exhibit A). The word typical is used to emphasize that there is no such thing as a standard oil and gas lease. Exhibit A is typical in that it contains most of the clauses customarily found in a modern oil and gas lease. That form will be used as the basis for discussing the types of disputes that commonly arise between lessors and lessees and how ADR may be used to help resolve such disputes.⁴² The principal clauses typically found in a modern oil and gas lease⁴³ are identified and briefly commented upon in the annotations in the right-hand column of Exhibit A.

42. A particular lease may or may not contain every "customary" clause. Further, the exact wording of these clauses may vary substantially.

43. More precisely, these are actually the principal clauses in paragraph eleven of the "typical" Texas Oil and Gas Lease Form, attached hereto as Exhibit A. Other areas of the country use leases which are similar but not identical. See *supra* note 21.

D. *Implied Covenants*

Disputes between lessors and lessees may arise under any of the express clauses of the lease, or they may arise under the so called implied covenants. Thus, any analysis of the potential of ADR to resolve disputes between lessors and lessees must encompass the implied covenants as well as the express clauses of the lease.

Implied covenants are unwritten promises that impose duties on the lessee⁴⁴ and protect the lessor. They are imposed by the courts and arise out of the relationship of the parties and the objective of the oil and gas lease.⁴⁵ Over the years the scholars and the courts have identified and listed at least six separate implied covenants.⁴⁶ These covenants are: Protect Against Drainage, Develop, Test,⁴⁷ Explore,⁴⁸ Market, and Operate Properly.

Today, there is a trend toward implying only one covenant—namely that the lessee will act as a reasonable and prudent operator. This unitary analysis utilizes one basic implied covenant with a number of different applications, depending on an infinite variety of

44. There are two implied covenants that run the other way, imposing duties on the lessor and protecting the lessee. They are the implied covenants of warranty and quiet enjoyment. ROGER A. CUNNINGHAM ET AL., *THE LAW OF PROPERTY* 865 (2d ed. 1993).

45. The implied covenants were created by the courts and like the express provisions of the lease, have evolved over the years. The best way to understand implied covenants is to think in terms of the underlying business deal, the relationship of lessee and lessor, and the expectations of both parties. See *supra* part II. A. As therein noted, production is the big payoff for both parties. The deal is structured so that both lessor and lessee will make money from good production. The lessor contributes the land and gives the lessee all of the operating rights. The lessee contributes the capital and know-how and assumes all operating risks. Under this type of arrangement, there is an implication that the lessee knows what he is doing and that he will perform competently, diligently, and in good faith. It is based on the same idea as hiring someone to build a house, repair a car, or trade securities. By virtue of being in the business of repairing cars, building houses, or acting as a stock broker, people assume certain implied duties, namely, that they know what they are doing and that they will do it competently, honestly and diligently. See LOWE, *supra* note 14, Chapter 11.

46. Some scholars classify the implied covenants slightly differently, but the basic idea is the same. See, e.g., RICHARD W. HEMINGWAY, *THE LAW OF OIL AND GAS* 445-47 (3d ed. 1991).

47. The implied covenant to test has been negated by the delay rental clause. Most courts have held that the presence of a delay rental clause in the lease obviates any implied covenant to test. See, e.g., *Warm Springs Dev. Co. v. McAulay*, 576 P.2d 1120 (Nev. 1978); *Eastern v. Beatty*, 177 P. 104 (Okla. 1918). See also HEMINGWAY, *supra* note 46, at 448-49.

48. The courts are split concerning the implied covenant to further explore. The Texas Supreme Court held that no implied covenant to further explore exists independent of the implied covenant of reasonable development. *Sun Exploration & Prod. v. Jackson*, 783 S.W.2d 202, 204 (Tex. 1989). However, under some circumstances reasonable development may carry a duty to do some further exploration. *Id.* Oklahoma is in accord with this view. See *Mitchell v. Amerada Hess Corp.*, 638 P.2d 441 (Okla. 1981). Other states recognize a covenant to further explore separate and distinct from the covenant of reasonable development. See, e.g., *Gillette v. Pepper Tank Co.*, 694 P.2d 369 (Colo. Ct. App. 1984). See also HEMINGWAY, *supra*, note 46, § 8.3.

fact patterns. *Amoco Production Co. v. Alexander*⁴⁹ is a good example of the application of the unitary analysis.

Under the unitary analysis, whether one is talking about drainage, development, marketing, or operations, if the lessee does what it takes to fulfill the business purpose of the lease, as required by the reasonable and prudent operator standard, all of the implied covenants should be satisfied. Conversely, if the lessee does not act like a reasonable prudent operator, he is likely to have breached one or more of the implied covenants.⁵⁰

Thus, determining the duties of a reasonable prudent operator will likely be the linchpin of any dispute involving an alleged breach of the implied covenants. The reasonable prudent operator standard is simply a vehicle for applying objective standards to flesh out the scope of the lessee's duty. The reasonable prudent operator standard is higher than the standard of good faith which is imposed on every party to a contract. However, the reasonable prudent operator is not a fiduciary.⁵¹ The reasonable prudent operator can act in his own self interest, but he must also: (1) act in good faith, (2) act as a competent operator, and (3) act with due regard for the interest of the lessor.⁵²

E. *The Need for Further Evolution*

The main purpose of this brief historical look at how the oil and gas lease evolved from something that resembled Exhibit B to something that resembles Exhibit A is recognition of the ongoing evolution of the oil and gas lease. This evolution has been responsive to underlying economics, development of scientific data, refinement of the underlying business deal, and, most important, the needs of the parties.

It is time for the lease document to evolve a little more. A compulsory ADR clause should be added to the modern lease form.⁵³ Before looking at the proposed new clause, we will examine the ADR process to determine whether ADR would be a useful tool for resolving disputes which arise under the oil and gas lease. We will also determine which of the various types of ADR procedures, if any, would be best suited to helping resolve such disputes.

49. 622 S.W.2d 563 (Tex. 1981).

50. See Lowe, *supra* note 14, at 306-09.

51. He is not a person who acts primarily for the benefit of someone else.

52. See Lowe, *supra* note 14, at 306-09.

53. See *infra* part VII.

III. AN OVERVIEW OF THE PRINCIPAL ADR PROCEDURES

ADR is generally defined as the use of a neutral third party (someone who has no stake in the outcome of the dispute) to facilitate resolution of disputes outside of a formal court of law.⁵⁴ This definition includes a broad range of procedures, which can be used separately or in various combinations. At the most basic level, ADR procedures can be broken down into adjudicative procedures, such as binding arbitration, in which the neutral third party has power to impose a solution on the disputants and consensual procedures, such as mediation, in which the neutral third party merely assists the disputants in arriving at their own solution.⁵⁵ The various procedures can best be understood if viewed on a continuum ranging from purely consensual to purely adjudicative. Certain procedures contain both consensual and adjudicative characteristics in varying combinations. Nevertheless, for purposes of definition and discussion, this paper classifies the various procedures discussed as consensual or adjudicative.⁵⁶

Working definitions of the principal ADR procedures illustrate the breadth and flexibility of the ADR process. For example, the Texas Alternative Dispute Resolution Procedures Act ("Texas ADR Act") adopted in 1987 refers to five dispute resolution procedures.⁵⁷ The procedures include: 1) mediation, 2) mini-trial, 3) moderated settlement conference, 4) summary jury trial, and 5) arbitration.⁵⁸ An earlier Act refers to a sixth, namely "private judging."⁵⁹ While these

54. See KIMBERLY K. KOVACH, *ADR—Does It Work?*, SOUTH TEXAS COLLEGE OF LAW, ADVANCE CIVIL LITIGATION INST. (1989).

55. CPR-TECHNOLOGY DISPUTES, *supra* note 5, at 2 & 7.

56. This distinction does not rest on whether the procedure is introduced by a court or by the disputants but solely on the power of the neutral third party to impose a solution. For example, a court may require the parties to mediate—a consensual procedure. The parties may have entered into an agreement containing a compulsory arbitration clause—an adjudicative procedure.

57. TEX. CIV. PRAC. & REM. CODE ANN. §§ 154.001-.073 (West Supp. 1995). Texas has several other statutes which pertain to ADR. Two such statutes are the Texas General Arbitration Act, TEX. REV. CIV. STAT. ANN., art. 224 to 238-26 (West 1987 & Supp. 1995) and the Trial by Special Judge Act, TEX. CIV. PRAC. & REM. CODE ANN. §§ 151.001-.013 (West Supp. 1995).

58. See TEX. CIV. PRAC. & REM. CODE ANN. §§ 154.023-27 (West Supp. 1995).

59. See *infra* note 78 for legislative history of the TEXAS PRIVATE JUDGING ACT originally enacted in 1983 and amended and recodified as TEX. CIV. PRAC. & REM. CODE ANN. § 151 (West 1987 & Supp. 1990).

are not the only available ADR procedures, they are the six procedures most often used both in Texas⁶⁰ and Oklahoma.⁶¹

A. Consensual Procedures

Mediation is most simply defined as facilitated negotiations.⁶² The disputing parties attempt to negotiate a voluntary settlement of their dispute with the help of a neutral third party (the mediator). In mediation the disputants communicate directly with each other and the role of the mediator is only to facilitate communication between the parties, assist them in focusing on the issues in dispute, and generate options for settlement. The goal of mediation is for the parties themselves to arrive at a settlement. The mediator has no power or authority to impose a settlement. Parties may voluntarily submit their dispute to mediation, or courts (by court order) may refer pending cases to mediation.⁶³ Mediation is more fully discussed below.⁶⁴

Summary Jury Trial is a procedure, authorized by statute in Texas⁶⁵ and several other states, which is sometimes initiated by the courts. Under this procedure the parties present an abbreviated version of their case to an advisory jury selected from the regular jury

60. In addition to defining the five ADR procedures listed above, the Texas ADR Act provides for referral of cases to ADR, either on motion of the court or of a party. TEX. CIV. PRAC. & REM. CODE ANN. § 154.021(a) (West Supp. 1995). The statute also gives the court authority to appoint neutral third parties, sets standards for neutral third parties, and provides for confidentiality. *Id.* §§ 154.021(a)(3), 154.051, 154.053 & 154.073.

61. The principal statutes which impact on ADR in Oklahoma are the Oklahoma Dispute Resolution Act, OKLA. STAT. ANN. tit. 12, §§ 1801-1813 (West 1993 & Supp. 1995) and the Uniform Arbitration Act, OKLA. STAT. ANN. tit. 15, §§ 801-818 (West 1993 & Supp. 1995). Like the Texas Arbitration Act, the Oklahoma Arbitration Act is derived from the Uniform Arbitration Act, versions of which have been adopted in many states. OKLA. STAT. ANN. tit. 12, ch. 21 (West 1993 & Supp. 1995) (the number of states adopting the Uniform Act are listed in the introduction to chapter 21). The Oklahoma Dispute Resolution Act is less extensive than the Texas ADR Act and deals only with mediation. Also it appears that mediation, generally, is used less extensively in Oklahoma than in Texas. However, the same principles discussed in this paper relating to the use of mediation as a tool for resolving disputes between lessors and lessees are equally applicable in Oklahoma as well as in Texas. *See generally* Jane J. Welch, *Mediation and Oklahoma's New Dispute Resolution Act*, 20 TULSA L.J. 114 (1984).

62. TEX. CIV. PRAC. & REM. CODE ANN. § 154.023(a) (West Supp. 1995) ("Mediation is a forum in which an impartial person, the mediator facilitates communication between parties to promote reconciliation, settlement, or understanding among them."). *See also* OKLA. STAT. ANN. tit. 12, § 1802(2) (West 1993 & Supp. 1995) ("Mediation means the process of resolving a dispute with the assistance of a mediator outside of a formal court proceeding.").

63. Court ordered mediations are called court-annexed mediations and must be authorized by statute. The TEXAS ADR ACT authorizes court annexed mediations but the OKLAHOMA DISPUTE RESOLUTION ACT does not. TEX. CIV. PRAC. & REM. CODE ANN. § 154.023(a) (West Supp. 1995).

64. *See infra* part IV & V.

65. TEX. CIV. PRAC. & REM. CODE ANN. § 154.026 (West Supp. 1995).

pool. The technique is used for "early case evaluation and development of realistic settlement negotiations."⁶⁶ After deliberation, the jury renders a non-binding advisory verdict. The parties and their attorneys then question the jurors, using the information to better evaluate their case. The advisory jury's verdict gives the parties a better understanding of the risks of going to trial and thus often fosters a negotiated settlement.⁶⁷

Mini-trial is another procedure authorized by statute in Texas, in which the parties engage in reality-testing before third parties.⁶⁸ The procedure is designed to set the stage for realistic settlement negotiations. The most distinctive characteristic of a mini-trial is that the attorneys present their case not to a judge, arbitrator or jury, but to the principals themselves. This process is usually used in complex corporate litigation. Attorneys for all sides present their best case to corporate executives with settlement authority, usually assisted by a neutral third party called an "expert advisor," whose judgment all parties trust. Negotiations by the corporate executives, usually without the attorneys present, follow the presentation. If no agreement is reached, the expert advisor may be asked to provide a non-binding opinion.⁶⁹

Moderated Settlement Conference is another case evaluation process, authorized by statute in Texas, which is designed to encourage settlement.⁷⁰ Typically, under a moderated settlement conference three experienced panel members, usually attorneys, listen to presentation of the case by all sides. The panel then questions the attorneys as well as the clients, who are present throughout the process. After deliberation, the panel renders an advisory, "non-binding" evaluation of the case, which is used as the basis for further settlement negotiation.⁷¹

B. *Adjudicative Procedures*

Arbitration is defined as a "process of dispute resolution in which a neutral third party (arbitrator) renders a decision after a hearing at

66. *Id.*

67. See TEXAS ADR HANDBOOK, *supra* note 4, at 75 and LEESON & JOHNSTON, *supra* note 9, at 23-24.

68. TEX. CIV. PRAC. & REM. CODE ANN. § 154.024 (West Supp. 1995).

69. See TEXAS ADR HANDBOOK, *supra* note 4, at 86; LEESON & JOHNSTON, *supra* note 9, at 114-15.

70. Moderated settlement conference is defined as "a forum for case evaluation and realistic settlement negotiations." TEX. CIV. PRAC. & REM. CODE ANN. § 154.025 (West Supp. 1995).

71. TEXAS ADR HANDBOOK, *supra* note 4, at 101.

which both parties have an opportunity to be heard.”⁷² In modern practice there are two types of arbitration—voluntary arbitration and court-annexed arbitration. In voluntary arbitration the parties agree in advance to submit their dispute to arbitration, usually pursuant to a compulsory arbitration clause in the contract. In court-annexed arbitration the courts refer a dispute to an arbitrator for decision as a precondition or substitute for trial.⁷³ Either voluntary or court-annexed arbitration can be binding or non-binding.⁷⁴

In this paper, unless otherwise expressly stated, all references to arbitration are to binding arbitration. Non-binding arbitration is not an adjudicative procedure, but rather a device used to foster voluntary settlement which has more in common with the mini-trial than with binding arbitration.⁷⁵ On the other hand, binding arbitration has much more in common with litigation than with the consensual procedures described above. The dispute is submitted to a neutral, non-governmental decision-maker called an arbitrator. The parties surrender control of the outcome by submitting their dispute to binding arbitration. While binding arbitration is an adjudicative process like litigation, it differs from litigation in several ways.⁷⁶

Private Judging started in California where the procedure is commonly referred to as “rent a judge.”⁷⁷ Today, several states have statutes⁷⁸ which allow the parties to refer their dispute to a privately compensated judge for decision.⁷⁹ A decision by a private judge has

72. BLACK'S LAW DICTIONARY 105 (6th ed. 1990).

73. TEX. CIV. PRAC. & REM. CODE ANN. § 154.021 (West Supp. 1995).

74. Often, voluntary arbitration or arbitration pursuant to an arbitration clause in a contract is binding and court annexed arbitration tends to be non-binding. However this is by no means universally true. In Texas, court-annexed arbitration is non-binding unless the parties stipulate to the contrary. TEX. CIV. PRAC. & REM. CODE ANN. § 154.027 (West Supp. 1995).

75. It is a fact finding procedure used for the purpose of helping the parties realistically evaluate the strengths and weaknesses of their respective cases.

76. See LEESON & JOHNSTON, *supra* note 9, at 47; CPR-OIL AND GAS, *supra* note 12, at 15. The main difference between arbitration and litigation is that arbitration is confidential and private. It is also generally more expeditious and less costly than litigation and it allows the parties to retain some control over the process. For example, the parties may select the arbitrator and set the standards and procedures which govern the arbitration hearing.

77. LEESON & JOHNSTON, *supra* note 9, at 21.

78. Texas first enacted a private judging statute in 1983. In 1987 the Texas Private Judging Act was amended and recodified as TEX. CIV. PRAC. & REM. CODE ANN. § 151.001-.013 (West 1989). See also W. Frank Newton & David G. Swenson, *Adjudication by Privately Compensated Judges in Texas*, 36 BAYLOR L. REV. 813 (1984). The use of private judging is rapidly growing in Texas. Oklahoma does not have a statute that authorizes private judging.

79. The term “private judging” is used in this paper only to refer to specific procedures authorized by statute which permits the trial of certain types of cases by privately compensated judges whose decisions generally carry the weight of trial court decisions and are generally appealable as such. It is not used to describe other procedures in which former judges serve as

substantially the same status as a decision rendered by a court of law for purposes of appeal and enforceability. Private judging, like binding arbitration, results in a resolution of the dispute. The two procedures are alike in that both the arbitrator and private judge have authority to impose solutions. Private judging differs from arbitration in that the private judge's decision is both appealable and enforceable. The arbitrator's award is non-appealable, except in very limited circumstances, and is enforceable only through a separate court action.⁸⁰

C. *Other ADR Procedures—Variations and Hybrids*

The brief discussion above of the most important ADR procedures illustrates the flexibility of ADR. The various procedures can be combined, tailored, and refined in an infinite variety of ways to meet specific needs. For example, mediation may be followed by binding arbitration. In this scenario mediation is first employed to attempt settlement of the dispute as a whole. If the mediation is unsuccessful, binding arbitration follows the mediation with a different neutral third party as the arbitrator. Any of the other procedures discussed above, such as summary jury trial or mini-trial, may be followed by binding arbitration. Similarly, a neutral fact finding procedure such as mini-trial or moderated settlement conference can be employed in connection with, as well as in lieu of, mediation.⁸¹

Mediation followed by arbitration should be distinguished from a hybrid procedure known as "med-arb." In a typical med-arb procedure, the parties agree in advance that dispute will be mediated and that the mediator will be given authority to arbitrate any unresolved issues.⁸² While the med-arb procedure assures resolution either through agreement or arbitrator's decision, it has a substantial disadvantage. The parties in mediation are not only permitted but encouraged, in confidential settings (i.e. caucuses) to engage in ex parte communications with the neutral third party. Weaknesses in the case

neutrals. See generally LEESON & JOHNSTON, *supra* note 9, at 21; Charles J. Williams, *Private Judging*, in TEXAS ADR HANDBOOK, *supra* note 4, at 117-31.

80. Under the Texas Private Judging Act a verdict rendered by a privately compensated judge is treated as a judgment that may be appealed to the same extent as any other judgment of a Texas district court. TEX. CIV. PRAC. & REM. CODE ANN. § 151.013 (West Supp. 1989). See also Texas ADR Handbook, *supra* note 4, 122.

81. This is the case in Texas, where all six of the ADR procedures discussed above are authorized by statute. In Oklahoma, the options are limited to some form of mediation or arbitration.

82. Karen L. Henry, *Med-Arb: An Alternative to Interest Arbitration in the Resolution of Contract Negotiation Disputes*, 3 OHIO ST. J. DISP. RESOL. 385, 389 (1988).

are often exposed in these sessions. The parties may be less than candid if they realize that when the neutral third party later takes off his mediator's hat and puts on his arbitrator's hat, he may rule against them.⁸³

Another hybrid which can be very effective is the mirror image of med-arb. For want of a better name I call it "arb-med."⁸⁴ In arb-med the neutral third party arbitrates the dispute and has authority to render an enforceable arbitration award. Before rendering the arbitration award, the arbitrator asks the parties if prior to delivery of the award they want to mediate the dispute and attempt to reach a voluntary negotiated resolution with the help of the neutral third party. If they answer in the affirmative, the neutral third party then takes off his arbitrator's hat and puts on his mediator's hat and attempts to mediate the dispute in the usual manner.⁸⁵

D. *Mediation Appears the Best ADR Procedure for Resolving Lessor/Lessee Disputes*

Of the various ADR procedures, mediation, either in its pure form or in some hybrid form, is the ADR technique best suited for resolving the disputes that arise between the lessor and lessee under the typical oil and gas lease. The reason is simple and straight forward. Mediation, unlike binding arbitration, has the disadvantage of not ensuring that the dispute will be resolved. Its principal advantage is that it allows the parties to work out their own solution. In most cases both parties to the oil and gas lease prefer to resolve their own disputes, rather than having solutions imposed on them by a judge or arbitrator. Thus a consensual approach seems clearly preferable to an

83. *Id.* at 397.

84. This author has spoken to several experienced arbitrator-mediators who have successfully used this procedure and I have successfully used it myself in a landlord tenant arbitration. Some neutral third parties add to the drama by placing their written arbitration award in a sealed envelope on the table in full view of the parties while they mediate the unresolved issues.

85. The ADR procedures mentioned do not exhaust the list of hybrids and variations. See TEXAS ADR HANDBOOK, *supra* note 4, at 133.

adjudicative approach for resolving disputes between lessors and lessees.⁸⁶ For this reason the principal focus of the remainder of this paper will be on mediation.⁸⁷

IV. CHARACTERISTICS WHICH SUPPORT RESOLUTION OF DISPUTES THROUGH MEDIATION

The principal factors to consider in deciding whether disputes arising under an oil and gas lease lend themselves to resolution through a consensual ADR procedure such as mediation are set forth below. In considering these factors, mediation should be compared to both litigation and arbitration as a dispute resolving mechanism. Two underlying concepts help put this inquiry into focus.

First, negotiation is the common element that links adjudication with mediation and the other alternatives to litigation. Without a system for resolving disputes through litigation, neither mediation nor any other form of ADR would likely exist.⁸⁸ Since the threat of litigation provides the impetus for the parties to settle a given dispute, the parties must believe that it is better to resolve a dispute through negotiation rather than to have a solution imposed upon them by a court.⁸⁹

86. See CPR—OIL AND GAS, *supra*, note 12, at 2; LEESON & JOHNSTON, *supra* note 9, at 136. If mediation fails to result in a solution, litigation is always available as a last resort. Also, in a multifaceted dispute partial solutions may result from the mediation.

87. The basic mediation process is not materially different in Texas and Oklahoma. Nor is that process materially different in most other states. Perhaps the best way to compare mediation as currently used in Texas and Oklahoma is to think of it as the same process with a few additional bells and whistles currently available in Texas.

88. All forms of ADR are alternatives to litigation. Many ADR commentators describe adjudication as a negotiating process supplemented by coercion and note that negotiation is the common element that links adjudication with ADR. See Bruce S. Marks, *Commercial Conflict Management and Alternative Dispute Resolution in the Oil and Gas Industry*, THE SOUTHWESTERN LEGAL FOUNDATION, 41ST ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 9-1, 9-45 (Carol J. Holgren ed. 1990).

89. The best evidence that most people share this view is that over 90% of all civil lawsuits filed are settled before judgment. See Marc S. Galanter, *Reading the Landscape of Disputes: What We Know and We Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 26-28 (1983). This same idea was more recently expressed as follows:

In commenting on an agreed judgment in which his firm agreed to pay the plaintiff approximately \$500,000 in a case involving alleged discrimination, Mr. James Hurlock, Chairman of White & Case, denied his firm engaged in discrimination. He characterized the agreed judgment as a "litigation tactic," to wit:

"The most uncertain of endeavors in life is litigation. And in a jury case it's even more uncertain. We're a big, allegedly wealthy firm against one individual, and we've got a Los Angeles jury."

Amy Stevens & Benjamin A. Holden, *How Bigotry Charges Rocked White & Case*, WALL ST. J., August 19, 1994, at B1.

Second, most parties genuinely want to explore all avenues that might lead to settlement and perceive that mediation may facilitate a mutually acceptable settlement even though the parties themselves may have failed to reach an agreement in unassisted negotiations.⁹⁰

A. *Disputes Between Parties Who Have a Continuing Relationship*

When the parties to a dispute have a continuing relationship, mediation is generally a better way to resolve the dispute than litigation or arbitration.⁹¹ Anecdotal examples abound about parties, driven apart by the bitterness engendered through litigation, who are unable to cooperate on matters subsequent to the litigation even when it is in their best interest to do so.⁹² The litigation itself, regardless of the outcome, may impair or destroy a relationship, which, in the long run, is more important than the outcome of the particular litigation.

Mediation "is far less adversarial than litigation or arbitration, and therefore less [likely to disrupt existing] relationships."⁹³ If the parties are able to resolve the dispute consensually through negotiations, the relationship which existed prior to the dispute may be preserved. In some instances, the relationship may even be strengthened because the parties sometimes come to appreciate each other's differing points of view.⁹⁴ Through mediation, each party typically gets part of what he or she wants and often the parties come away from the settlement with a new level of rapport and understanding. Mediation

90. "Negotiation is the . . . time-honored initial step in attempting to resolve disputes." See CPR-OIL AND GAS, *supra* note 12, at 25.

91. A retired Chief Justice of the Oregon Supreme Court, Arno Denecke, observed: "If the parties are going to be in a continuing relationship after the dispute anything other than mediation is a mistake. . . . Litigation can leave lasting scars, and arbitration is still confrontational." [W]ith mediation, the resolution the parties hammer out is theirs, not something imposed by a third party." 2 ALTERNATIVE DISPUTE RESOLUTION REPORT (BNA) 209 (1988) [hereinafter ADR REPORT].

92. One example is found in a well known 1917 contracts case *Brackenbury v. Hodgkin*, 102 A. 106 (Me. 1917). In that case Mrs. Hodgkin, a widow who lived on a farm in Maine, wrote Mrs. Brackenbury, one of her children, who lived in Missouri, offering Mrs. Brackenbury the use and income from the farm if she and her husband would move to Maine and care for Mrs. Hodgkin for the rest of her life. *Id.* at 107. The Brackenburys moved and began caring for Mrs. Hodgkin, but the parties did not get along and Mrs. Hodgkin brought suit to force the Brackenburys to leave. *Id.* The court held the Brackenburys had a valid contract and allowed them to stay. *Id.* Following the litigation it is reported that the Brackenburys and Mrs. Hodgkin continued to live together until Mrs. Hodgkin's death in 1921 and that the relationship was unpleasant until the very end. E.A. FARNSWORTH & W.F. YOUNG, *CASES AND MATERIALS ON CONTRACTS* 216 (4th ed. 1988). Mr. Brackenbury obtained a transcript of the law suit and would from time to time read it to the old lady. *Id.*

93. CPR—OIL AND GAS, *supra* note 12, at 6.

94. Sometimes the mediation process turns adversaries into mutual problem solvers. See Lon L. Fuller, *Mediation—Its Forms and Functions*, 44 S. CAL. L. REV. 305, 326 (1971).

of one dispute may also serve as a model for resolving future disputes.⁹⁵

In the oil and gas context, the unique nature of the relationship between lessor and lessee may offer even greater incentives than usual for resolution of disputes through consensual means. For example, assume O is the fee owner of a 160 acre farm called Blackacre. He raises cotton and vegetables on the Blackacre farm and typically earns an annual net profit of between \$40,000 and \$50,000. Assume further that O has leased Blackacre to E under an oil and gas lease pursuant to which O receives a 1/6 royalty and E has drilled two oil wells on Blackacre. Each well produces on average 100 barrels of oil a day.

Under this scenario: (1) both O and E share the use of Blackacre;⁹⁶ (2) both operate separate businesses on the property;⁹⁷ (3) O has an interest in the business operated by E;⁹⁸ and (4) there is great economic disparity between the revenues and profits from the business operated by E and those from the business operated by O.⁹⁹ While these factors often lead to disputes, the same factors provide incentives for resolving the disputes consensually. The interests of O and E are so intertwined that there are likely to be both common grounds and economic incentives for both parties to resolve the dispute.

Mediation does not address who is right and who is wrong. It avoids a clear winner and loser. It "speaks only of who will do what," when it will be done, and how the problem will be resolved.¹⁰⁰ The "absence of fault-finding—plus the experience of working cooperatively" toward a mutually agreeable solution can help preserve a relationship, which adjudication might destroy.¹⁰¹

95. TEXAS ADR HANDBOOK, *supra* note 4, at 39.

96. The lessee E has the right to use as much of the surface as is reasonably necessary to explore for and produce minerals. Invariably from time to time E will get in O's way.

97. E's business is the production of oil and O's business is farming.

98. His 1/6th royalty, entitles him to one of every six barrels of oil produced from the property.

99. Assuming both wells produce 100 barrels of oil a day 360 days a year and that oil sells for \$20 a barrel, the wells will generate total revenue of approximately \$1,440,000. O's royalty share of that revenue will be approximately \$240,000 a year. Assuming E's operating expenses are \$200,000 a year, which is assumed simply for purposes of making the math as simple as possible, E still will have net profits of approximately \$1 million a year from the oil business. This is far in excess of the \$50,000 maximum earned from the farm. *See infra* part VI.B.2.

100. LOVENHEIM, *supra* note 8, at 23.

101. LOVENHEIM, *supra* note 8, at 23.

B. *Disputes in Which the Best Solution Involves Remedies Courts Cannot Provide*

In many disputes the best remedies for both parties are remedies that courts cannot provide. In business disputes generally, and disputes involving oil and gas in particular, the best solution often entails renegotiating a contract or a deal—a solution that is possible through mediation but not through adjudication.¹⁰² Frequently, the parties, with the help of a mediator, can develop a “value creating” solution which operates to the benefit of both parties. This requires cooperation and can come only through a consensual mechanism.¹⁰³ Often such solutions involve complex trade-offs, which call for flexibility, creativity, and negotiating skills. Sometimes one of the parties invents a solution and then sells it to the other party. That solution is usually then refined through further negotiations.

Mediation gives the oilman a forum for employing the negotiating and deal making skills for which oilmen are famous.¹⁰⁴ The assistance of the mediator in facilitating communication may help expose the real interest or agenda of the parties, which is a vital element in the negotiating process. While resolving disputes through mediation is not quite like doing deals at the Petroleum Club, it has more in common with the club than the courthouse.

C. *Where the Parties Want to Retain Control Over the Resolution of Their Dispute*

In most lessor/lessee disputes, the parties prefer to retain as much control as possible over the resolution of the dispute rather than relinquishing such control to a judge or arbitrator. In mediation, the parties control the mechanics and procedural aspects of the process, such as where and when the mediation will occur, how the costs will be paid, what procedural rules will be followed and similar details. The

102. Courts are limited in the types of remedies they can provide. The usual remedy is damages. Equitable remedies such as specific performance and reformation are available in limited situations. Often none of these remedies are appropriate to resolve lessor/lessee disputes.

103. See CPR—OIL AND GAS, *supra* note 12, at 13.

104. When these skills are applied toward resolving lessor/lessee disputes, the lessor, as well as lessee, may benefit from the oilman's creativity and deal making skills.

parties can propose substantive solutions that make sense from a business as well as a legal standpoint.¹⁰⁵ Most importantly, only the parties have authority to settle the matter or advise the mediator that an impasse has been reached.

Mediation, offers far greater flexibility and gives the parties the opportunity to work out their own solutions. It not only permits but also requires that the parties play a more active role than they typically play in litigation or arbitration. Most business disputes are best resolved if they are approached as business problems with legal aspects rather than as legal contests. The parties must share a genuine desire to resolve the dispute¹⁰⁶ and must accept responsibility for resolving it, even if doing so requires one or both of them to change their position.¹⁰⁷

D. *Where the Parties Want a Forward-looking Resolution of the Dispute*

"Mediation is a forward-looking process."¹⁰⁸ Unlike litigation and arbitration which look backward to determine "who was right and who wrong; mediation, looks [forward] to find a solution [the] parties can live with."¹⁰⁹ "The adjudicatory processes . . . require findings of fact about events that occurred in the past."¹¹⁰ Based on those findings, rights and duties are assigned and remedies imposed under applicable law or the provisions of applicable documents. By contrast, determining what happened in the past is not the central point of focus in mediation. Rather the main focus is on future conduct which will help resolve the problem which gave rise to the dispute.¹¹¹

105. They can also help structure settlements in ways most courts cannot and bring into play negotiating and deal making skills for which some in the oil business is famous. *See supra* part IV.B.

106. Ironical as it may seem, sometimes parties who say they want to resolve the dispute in fact want to perpetuate it. LEESON & JOHNSTON, *supra* note 9, at 140.

107. LEESON & JOHNSTON, *supra* note 9, at 140-41. *See also* CPR—OIL AND GAS, *supra* note 12, at 6-7.

108. LEESON & JOHNSTON, *supra* note 9, at 133.

109. LOVENHEIM, *supra* note 8, at 13.

110. LEESON & JOHNSTON, *supra* note 9, at 133-34.

111. *See* LEESON & JOHNSTON, *supra* note 9, at 133-34.

E. *Where Privacy and Confidentiality are Important*

Whether the mediation is voluntarily instituted by the parties or ordered by the court, it is a private proceeding. What occurs in a mediation is known only to the parties and their mediator.¹¹² Conversely, everything said or submitted in a law suit, except in rare cases, becomes public information.¹¹³

Mediation is also confidential. Both the Texas ADR Act and the Oklahoma Dispute Resolution Act specifically provide that communications made in, and records relating to, alternative dispute resolution procedures covered by those Acts are confidential.¹¹⁴ Such communications and records are not subject to discovery and are inadmissible in any judicial or administrative proceeding. Thus, neither the principals nor the neutral third party must testify, nor must they disclose confidential information. In addition, the neutral third party may not disclose confidential information to either party, unless expressly authorized to do so by the party providing the information.¹¹⁵ The sole exception to the confidentiality rule is that communications or records that would be admissible or discoverable independent of the ADR process do not become inadmissible or nondiscoverable simply by reason of their use in an ADR proceeding.¹¹⁶

There are at least three aspects to confidentiality. First, when a disputant meets with the mediator in a private "caucus" and makes disclosures to the mediator that he would be unwilling to reveal to his opponent, he knows the mediator will not reveal those disclosures to the opponent without permission. Second, the disputants know that nothing said or done during the mediation will later be used against them in a subsequent proceeding. Third, the disputants know that the mediator will not only refuse to testify as to anything that went on

112. See LEESON & JOHNSTON, *supra* note 9, at 133.

113. FED. R. CIV. P. 77(b) (stating in part that all trials upon the merits shall be conducted in open court and, so far as convenient, in a regular court room).

114. TEX. CIV. PRAC. & REM. CODE ANN. §§ 154.073 (West Supp. 1995); OKLA. STAT. ANN. tit. 12, § 1805 (West 1993 & Supp. 1995). See also Jay F. Lapin and Roger J. Patterson, *Alternative Dispute Resolution: New Strategies for Litigation and Settlement of Claims*, THE SOUTHWESTERN LEGAL FOUNDATION PROCEEDINGS OF THE FORTY-FIRST ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 6.04[3][a] (1990). See also Welch, *supra* note 61, at 120-28.

115. TEX. CIV. PRAC. & REM. CODE ANN. §§ 154.073 (West Supp. 1995); OKLA. STAT. ANN. tit. 12, § 1805 (West 1993 & Supp. 1995).

116. Settlement discussions cannot be used as a vehicle to shield otherwise discoverable material from discovery. TEX. R. CIV. EVID. 408; FED. R. EVID. 403 & 408; FED. R. CIV. P. 26 (b)(1).

during the mediation, but will also refuse to reveal information about the proceeding to anyone, including family, friends or the press.¹¹⁷

The principle of confidentiality in mediation rests on the broad based policy of encouraging disputants to freely disclose information, which aids in the resolution of disputes. Mediators also place a high premium on confidentiality. They generally make no transcripts and resist efforts to force them to testify or otherwise reveal information.¹¹⁸ Privacy and confidentiality are generally desired in business disputes.¹¹⁹

F. *Where the Parties Have Differing Assessments of the Law and/or the Facts*

Unassisted negotiations often break down because the parties have different perceptions of the law or the facts. Parties usually base their settlement positions on their assessment of the probable outcome of litigation over the matter in dispute. Perceptions may differ in this regard and it is not uncommon for each party to be unduly optimistic as to its chances of success. Effective mediation is likely to lead to a more realistic appraisal of the law and the facts by the parties and thereby enhance the prospects for settlement.¹²⁰

Mediators can encourage exchanges of information, provide new information, uncover the sources of the differing perceptions and expose weaknesses in either party's position. Weaknesses are usually pointed out in confidential caucuses with each party.¹²¹ Effective mediators can diplomatically compel the parties to face facts, persuade them to understand the other party's point of view, and dispel unrealistic expectations.¹²²

Sometimes negotiations break down or never commence simply because the parties are too angry to communicate effectively. Also the parties might be reluctant to initiate negotiations for fear that such

117. See NANCY ROGERS & CRAIG MCEWEN, *MEDIATION: LAW POLICY AND PRACTICE* (1989 & Supp. 1991). This source contains a detailed treatment of confidentiality and summarizes the state laws protecting confidentiality in the mediation process.

118. See Eileen P. Friedman, *Protection of Confidentiality in the Mediation of Minor Disputes*, 11 CAP. U. L. REV. 181 (1982).

119. The oil and gas industry particularly seems to relish privacy and confidentiality and has a unique term for these concepts—"tightholing."

120. See CPR—OIL AND GAS, *supra* note 12, at 14.

121. Practices and procedures vary substantially in this area: some mediators are reluctant to express opinions while others have no hesitancy in this regard. See NANCY H. ROGERS & RICHARD A. SALEM, *A STUDENT'S GUIDE TO MEDIATION AND THE LAW* 48, 110-15 (1987).

122. CPR—OIL AND GAS, *supra* note 12, at 8.

an overture would be interpreted as a sign of weakness. In these situations mediators can facilitate negotiations by simply providing a neutral setting and creating a positive environment. They can also promote a productive level of communication and emotional expression, let the parties vent their anger and let them know their concerns are understood.

G. *Where the Parties Want to Minimize Time and Costs*

All parties want to save time and costs. Mediation reduces both time and costs in an overwhelming majority of cases. Studies show that mediations which result in agreements universally resolve the matters in dispute faster than litigation.¹²³ Such studies show that mediations are typically concluded within months or weeks after initiation of the mediation, which refers to the order, in the case of court annexed mediations, or, in the case of voluntary mediations, implementation of the agreement to mediate. In the case of litigation, final resolution typically takes years.¹²⁴ In this regard it should be noted that, while more than approximately ninety percent of litigated disputes are settled before judgement, settlement discussions do not usually get serious until a trial date is near. Thus the speed of mediation facilitates faster settlements by forcing the parties to bite the bullet earlier.¹²⁵

Studies show that both time and costs are significantly reduced by mediation.¹²⁶ Research shows that, on average, about ninety-eight percent of a party's civil litigation costs are attorney's fees.¹²⁷ Thus, the means of resolving a dispute that requires the fewest hours of work by lawyers is the least costly means of resolving that dispute. Of course, mediators charge a fee and the parties may be represented by attorneys in the mediation process. Costs incurred in mediation vary widely depending on the length and complexity of mediation and whether lawyers attend the mediation. Nevertheless, studies show that where mediation results in agreement, costs are far less than

123. ROGERS & SALEM, *supra* note 121, at 44. See also LOVENHEIM, *supra* note 8, at 10 (stating that "most disputes at public mediation centers can be scheduled for a hearing within two to three weeks; average time per hearing is about one and one-half hour.").

124. The exact time of resolution varies significantly depending on local dockets and whether or not appeals are pursued. Chicago's Cook County Circuit Court took an average of 69 months for a case to come to trial compared with an average of 13.7 days from intake to final disposition in New York State's 1987-88 public mediation system. LOVENHEIM, *supra* note 8, at 26-27.

125. See CPR—BUSINESS DISPUTES, *supra* note 10, at 12.

126. LOVENHEIM, *supra* note 8, at 10.

127. LOVENHEIM, *supra* note 8, at 10.

those incurred in litigation; and, even where mediation does not result in agreement, costs are about the same as in cases where mediation is not used.¹²⁸

H. *Mediation Appears to be the Process of Choice*

While mediation seems generally preferable to adjudication as a vehicle for resolving lessee/lessor disputes in most cases, like any general statement this one is subject to certain caveats and exceptions. For example, mediation is inappropriate where one or both of the parties wants to establish a precedent. Winning test cases, proving the truth of something or establishing a precedent can not be done through mediation because mediation agreements do not establish right and wrong and are not binding precedents for future disputes.¹²⁹ Also, there is no guarantee that mediation will resolve the dispute. If mediation fails, the dispute will have to be resolved through adjudication. However, since the adjudicatory options are not foreclosed if mediation fails, there is little or no risk in mediating.¹³⁰

V. THE MEDIATION PROCESS

A. *How to Initiate Mediation*

There are a number of ways in which mediation may be initiated. If the parties are in litigation, under the Texas ADR Act and similar acts now in effect in many states, the court can order the parties to mediate.¹³¹ Further, either party may move the court to refer the matter to mediation.¹³² The parties may also voluntarily initiate mediation as an extension of the negotiating process.¹³³

The principal focus of this paper is on the initiation of mediation through advance agreement, that is, through a compulsory mediation clause in the oil and gas lease. Under such a clause the parties agree in advance that future lease disputes will be referred to mediation prior to either party initiating litigation.¹³⁴

128. LOVENHEIM, *supra* note 8, at 10.

129. LOVENHEIM, *supra* note 8, at 26.

130. See CPR—OIL AND GAS, *supra* note 12, at 5.

131. TEX. CIV. PRAC. & REM. CODE ANN. §§ 154.021-022 (West Supp. 1995).

132. *Id.*

133. The basic distinction is between "voluntary" mediation where the parties initiate the process of their own volition and "mandatory" mediation where the process is initiated by court order. See LEESON & JOHNSTON, *supra* note 9, at 135, 140.

134. See CENTER FOR PUBLIC RESOURCES-DISPUTE RESOLUTION CLAUSES-A GUIDE FOR DRAFTERS OF BUSINESS AGREEMENTS 1 (1994) [hereinafter CPR-DISPUTE RESOLUTION CLAUSES] (noting that "[b]y far the best time to agree on a sensible way to resolve a contractual

B. *Role of the Mediator*

While the mediation process may get the parties to the table, it does not necessarily get them there in a frame of mind to settle. Skilled mediators strive to provide the impetus for settlement by altering the mind set of the disputants, changing the dynamics of negotiations and helping the disputants find mutually acceptable solutions.¹³⁵

The mediator's role can run the gamut from that of a mere facilitator, who arranges meetings, provides a neutral setting and passively presides over the meetings to that of an activist who proposes settlement terms and urges the parties to accept those terms.¹³⁶ The role mediators perform varies from mediator to mediator and from dispute to dispute, but generally includes at least the following: (1) they act as conveners, assisting the parties in defining the issues in controversy and the terms and conditions under which they will negotiate; (2) they act as brokers, conveying the concerns and ideas of one party to the other, either in joint session or in separate confidential sessions with the respective parties; and (3) they act as facilitators, often suggesting alternative approaches or compromises which may assist the parties in reaching agreement and bringing about a resolution to the dispute.¹³⁷

While the mediator may assume a variety of other roles, the one role he or she can never assume is that of judge. By definition, the mediator, unlike the judge or arbitrator, has no power to impose an outcome on the disputing parties. The mediator's sole function is to assist parties in finding a solution of their own making. In most cases successfully helping the parties to find a solution to a problem, which they failed to do on their own for months or years is not an easy task and involves much more than simply getting the parties to talk about

dispute is when the parties are negotiating their business agreement and before any dispute has arisen").

135. The skillful mediator tries to get the disputants to change from regarding their business dispute as a contest to be won or lost to a problem to be solved. Once this shift in attitude takes place some of the hostility tends to defuse and the dynamics of the negotiation tend to change. The parties and the mediator begin to exchange ideas and strive to invent creative solutions to the problem. The dynamics of mediation foster settlement. See CPR—BUSINESS DISPUTES, *supra* note 10, at 13; CPR—OIL AND GAS, *supra* note 12, at 6.

136. See CPR—OIL AND GAS, *supra* note 12, at 6; see also CPR—BUSINESS DISPUTES, *supra* note 10, at 19 (providing a continuum of how large a role a mediator might assume in a given dispute).

137. See Bruce S. Marks, *Commercial Conflict Management and Alternative Dispute Resolution in the Oil and Gas Industry*, THE SOUTHWESTERN LEGAL FOUNDATION, PROCEEDINGS OF THE FORTY-FIRST INSTITUTE ON OIL AND GAS TAXATION 9-46 (1990). See also WALTER MAGGIOLO, *TECHNIQUES OF MEDIATION* 91 (1985).

their problem. The skilled mediator attempts to move the parties from their fixed positions and help them find a solution to their dispute. The techniques employed may include the following: (1) setting an agenda and ground rules to govern the negotiations; (2) enhancing and controlling communications between the parties, which might include carrying messages between the parties and helping them negotiate; (3) helping the parties discover and better define the true issues involved in the dispute; (4) helping each party understand the wants and needs of the other party; (5) helping the parties understand the facts and face the facts, sometimes creating an impetus to settle by confidentially pointing out weaknesses in the positions of the respective parties; and (6) helping the parties develop and negotiate proposed solutions.¹³⁸

C. Overview of Mediation Techniques and Mediator Qualifications

There is no "best" way to mediate a dispute. Mediation techniques vary with the mediator, the parties and the dispute. Likewise, there is no right or wrong style of mediation, nor is there a definitive checklist of qualifications an effective mediator must possess or techniques that an effective mediator should employ. Similarly, there is no set model defining the process. On the contrary, mediation is characterized by its flexibility and takes shape in a variety of models.¹³⁹ Two attributes are, however, essential for all mediators. First, the mediator must earn the trust of the parties¹⁴⁰ and second, the mediator must be a skilled listener.¹⁴¹

To attain trust, the mediator must be perceived by the parties as absolutely fair, impartial, and free of any conflicts of interest. In addition, the mediator must convince the parties that he or she understands their dispute, will keep their confidences, is capable of understanding the law and the facts¹⁴² and has the skill to guide them to a negotiated settlement. Only after trust has been established will

138. See LOVENHEIM, *supra* note 8, at 35-36. See also CPR—BUSINESS DISPUTES, *supra* note 10, at 19.

139. See generally ROGERS & SALEM, *supra* note 121, at ch. 2; LOVENHEIM, *supra* note 8, at 33-46; TEXAS ADR HANDBOOK, *supra* note 4, at § 3.7.

140. ROGERS & SALEM, *supra* note 121, at 11.

141. ROGERS & SALEM, *supra* note 121, at 11.

142. One commentator, who has evaluated the need for referral to knowledgeable industry experts in the context of gas contract dispute arbitrations, has noted the value of using duly constituted state commissions:

[C]ontractual ratable take and drainage claims require significant factual development and technical expertise. . . . A proceeding involving these types of claims at the [Texas Railroad Commission's Oil and Gas Division,] is an administrative process . . . in many

the parties be totally candid with the mediator, disclose their real interests, and act on the mediator's suggestions.

The mediator must be an expert listener. He or she develops an understanding of the dispute through careful listening. Further, mediators are generally accorded confidence and respect only after they convey to the parties the fact that they understand the essence of both the dispute and the respective parties' concerns. Often this understanding is conveyed through empathetic or active listening, which means listening for what the parties feel as well as to what they are saying. The mediator conveys that he or she is listening empathically through verbal and nonverbal (i.e. eye contact and body language) feedback that lets the parties know that the mediator understands and respects their positions.¹⁴³

Beyond earning trust and being expert listeners, mediators' techniques and strategies vary as widely as do the mediators themselves and the disputes which they mediate. Despite this diversity, both scholars and experienced practitioners who have written about the mediation process tend to agree that successful mediators tend to possess certain basic qualifications and tend to apply certain basic techniques. This is not to imply that all techniques will be used in all proceedings or that any single mediator will possess all of the qualifications listed. It is merely an effort to describe in generic terms, without being exhaustive, the most common techniques and most sought after qualities.¹⁴⁴

ways like arbitration. If questions of law requiring an understanding of state and federal regulations, such as proration rules, figure in . . . [the] defenses . . . , arbitration before individuals knowledgeable in the industry [may be preferable.]

Marks, *supra* note 137, at § 9.04[4] (quoting Bowman, *Arbitration of the Gas Contract Dispute: An Alternative to Litigation*, NATURAL GAS LITIGATION INSTITUTE (Oct. 11-12, 1988)).

143. ROGERS & SALEM, *supra* note 121, at 12-13.

144. STEPHEN B. GOLDBERG ET AL., *DISPUTE RESOLUTION* 103 (2d ed. 1992). While even summary treatment of these techniques and qualifications is beyond the scope of this paper, I have set forth below two of the better checklists obtained from the vast array of literature on the subject of how to mediate. The following is a checklist of the most commonly employed techniques used by mediators:

- (1) Encouraging exchanges of information and providing new information;
- (2) Helping the parties understand one another's views;
- (3) Letting the parties know that their concerns are understood;
- (4) Promoting a productive level of emotional expression;
- (5) Helping the parties to realistically assess the alternatives to settlement;
- (6) Encouraging flexibility;
- (7) Stimulating the parties to suggest creative settlement options;
- (8) Learning about matters the parties are reluctant to disclose to each other;
- (9) Creating solutions that meet the fundamental needs of all parties.

Id.

The following is a checklist of qualifications for mediators of complex business disputes:

D. *Overview of the Steps in the Mediation Process*

Just as there is no "best" way to mediate a dispute, there is no standard model which dictates the steps in the mediation process. On the contrary, mediation, a process characterized by its flexibility, takes shape in a variety of models.¹⁴⁵ Nevertheless, in spite of variations, some commonality exists and a general overview of the steps in the process helps to illustrate how the mediation process works.¹⁴⁶

The Texas ADR Handbook describes mediation as a three-step process.¹⁴⁷ Others have described mediation as a six-step¹⁴⁸ and a twelve-step¹⁴⁹ process. On analysis, these descriptions are consistent with one another. The variation in description merely reflects the fact that the various steps in the process overlap and merge together. The three-step process (which this paper uses for purposes of providing a general overview of the mediation process) consists of the following: (1) opening and explanation phase; (2) bargaining and negotiation phase; and (3) closure.

During the opening and explanation phase, the mediator makes an opening statement. In addition to defining the ground rules and procedures the mediator seeks to create an atmosphere which fosters

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- (1) Perceived as absolutely impartial and fair;
 - (2) Capable of inspiring trust and confidence;
 - (3) Ability to assess people, understand their motives, and relate easily with them;
 - (4) Ability to maintain a tone of civility and consideration;
 - (5) Excellent listening skills;
 - (6) Capable of thoroughly understanding the law and facts of a dispute;
 - (7) Ability to analyze complex problems;
 - (8) Creativity, ingenuity, and imagination in developing viable proposals;
 - (9) Skills as a problem solver;
 - (10) Ability to be articulate and persuasive;
 - (11) Flexibility;
 - (12) Patience and persistence in the face of difficulties;
 - (13) A personal stature which commands respect;
 - (14) Experience as a mediator.

CPR—BUSINESS DISPUTES, *supra* note 10, at 18. This checklist sets forth a rare combination of qualities unlikely for any one mediator to possess. The size and complexity of the case will influence the qualifications required. In a major case, the mediator will likely be a former judge, a professor, a highly respected attorney, or a business executive, preferably with ADR experience and some knowledge of oil and gas.

145. See generally ROGERS & SALEM, *supra* note 121, at ch. 2; LOVENHEIM, *supra* note 8, at 33-46.

146. See ROGERS & McEWEN, *supra* note 117, at 12.

147. TEXAS ADR HANDBOOK, *supra* note 4, at 47.

148. LOVENHEIM, *supra* note 8, at 103 (describing the six stages of a mediation hearing as (1) mediator's opening statement, (2) disputants' opening statements, (3) discussion, (4) caucus, (5) negotiation, and (6) closure).

149. CHRISTOPHER MOORE, THE MEDIATION PROCESS: PRACTICAL STRATEGIES FOR RESOLVING CONFLICTS 25 (1986).

trust, communication and cooperation. The skillful mediator will subtly tout the benefits of mediation, such as the preservation of long-term business relationships between the parties and the fact that mediation can yield agreements in which both parties win, as opposed to the win/lose decisions of courts. The mere mention of court decisions may be a sufficient hint that the dispute, if unresolved, may end in court. The skillful mediator also uses the opening statement to begin altering the mind set of the disputants from regarding their dispute as a contest to be won or lost to a problem to be solved.¹⁵⁰

Typically, following the mediator's opening statement, each party makes an opening statement setting forth their respective side of the dispute. The purpose of these opening statements is multifold. But most importantly, it allows the mediator to begin to frame the issues which will need to be addressed. An astute mediator often will be able to discover both areas of concern and areas of agreement from these opening statements.

After the opening statements are concluded, the mediator may ask the parties further questions regarding the dispute in order to elicit discussion. During this part of the process, the mediator's primary job is to listen. He or she should be particularly sensitive to hidden agendas or other issues not discussed in the opening statements. The parties should be allowed to "vent" their anger.¹⁵¹

During the bargaining and negotiation phase, the mediator meets with the parties in joint sessions and also meets with each of the parties in private sessions called caucuses.¹⁵² There is no prescribed formula that mandates how much of the negotiating is done in joint session and how much is done in caucus where the mediator shuttles between the parties in an effort to resolve the dispute. In caucuses the principle of confidentiality is crucial. The mediator assures each party that he or she will not reveal private information revealed during the caucus without permission.

In both joint sessions and caucuses, the mediator listens and asks questions designed to discover areas of concern and hidden agendas. To mediate means "to go between" or "to be in the middle." Thus, the term accurately describes what the mediator does. He or she goes

150. TEXAS ADR HANDBOOK, *supra* note 4, at 48.

151. "Venting" is a mediation term-of-art which describes a most important part of the process. Unlike proscribed courtroom behavior, in mediation the parties are allowed to get angry and express their anger. This is an important part of the settlement process in mediation.

152. "Caucus" is a mediation term-of-art which describes a separate and confidential meeting between the mediator and one of the parties.

between the parties to help them find a solution to their dispute. The mediator elicits information. With information comes the power of knowledge and the likelihood of finding areas of mutual agreement. The mediator guides the parties in exploring all available alternatives for settlement.¹⁵³

Once one or more potential solutions reach the table, the mediator attempts to channel the various proposals into a mutually acceptable solution. If proposed solutions are offered during a caucus, the mediator must ask the party's permission to share the solution with the other side. Such proposals may deal with a party's alleged "bottom-line" position. Often the proposals turn out to be mere posturing. It may be necessary for the mediator to create an impetus to settle by privately pointing out weakness in the positions of the respective parties or to augment the proposals of the parties with suggestions of his own.¹⁵⁴

Closure occurs either when the parties reach an agreement or when the mediator determines no agreement will be reached and that further efforts to reach agreement would be futile. If no agreement is reached the mediator should close the proceeding on the most positive note possible.

If the mediation is successful and an agreement has been reached, closure entails committing that agreement to writing. The written agreement, like everything else in the mediation proceeding, is the work product of the disputants and the mediator. Many mediation proceedings have bogged down at the eleventh hour because the parties were unable to agree on language describing a settlement that they had verbally agreed to earlier.¹⁵⁵

The task of writing the agreement is not unlike that of drafting a contract or a settlement agreement in unstructured direct negotiations. The contract analogy is particularly appropriate because, if one

153. TEXAS ADR HANDBOOK, *supra* note 4, at 49.

154. Suggestions by the mediator must be made very carefully, since it is desirable that the settlement be the parties' rather than the mediator's. Suggestions by the mediator must be as neutral as possible to avoid any hint of bias. The mediator may offer several possible solutions for each difficult point, allowing the parties to choose, or better yet, plant the seed so that the disputants may discover the optimum solution themselves.

155. TEXAS ADR HANDBOOK, *supra* note 4, at 50; LOVENHEIM, *supra* note 8, at 104-17.

of the parties does not live up to the agreement reached in mediation,¹⁵⁶ the other party's remedy is an action for breach of contract.¹⁵⁷

E. *Desirability of Mediation—Business and Practical Considerations*

The types of disputes that typically arise between lessors and lessees under the oil and gas lease would seem to readily lend themselves to resolution through mediation. One would assume that oil companies, which typically prepare the leases, would encourage the use of mediation¹⁵⁸ and routinely insert mediation clauses into their leases. However, few domestic oil and gas leases today have such clauses and, aside from court annexed mediation or arbitration and international situations, ADR is not often used in the oil and gas industry.¹⁵⁹

Can the absence of ADR clauses be attributed to fear that such clauses would cause a company to lose deals? In other words, would a compulsory ADR clause cause a prospective lessor not to lease to a company, which offers a lease with a compulsory ADR clause but rather lease to a competitor, who offers substantially the same deal without such a clause?

Probably not in most cases.¹⁶⁰ If the bonus and the royalty are competitive, a compulsory ADR clause would cause the loss of few, if any, agreements. If problems arose, an ADR clause would simply be another element to negotiate at the time the lease is signed.¹⁶¹

156. To the limited extent such statistics are available, they show that in the overwhelming majority of cases the parties voluntarily comply with agreements reached in mediation proceedings. In fact, it has been statistically shown that parties are more likely to comply with the terms of a mediation agreement than to abide by a court order. See LOVENHEIM, *supra* note 8, at 110, Ch. 1.

157. LOVENHEIM, *supra* note 8, at 110. See also *Ames v. Ames*, 860 S.W.2d 590, 591 (Tex. Ct. App. 1993), *rev'd on other grounds* (holding agreement reached in mediation proceeding to be enforceable as a contract).

158. Generally, the oil company is also much more likely to be the defendant rather than the plaintiff in cases arising under the lease.

159. This writer has never seen a compulsory ADR clause in a domestic oil and gas lease. While I have looked for empirical studies to determine the frequency in which ADR is used in the oil and gas industry, I was unable to find any such studies and have been advised by reliable sources that no such studies exist. A number of random calls to oil and gas practitioners and mediators have confirmed my impression that, except in international cases, ADR clauses are not frequently used in the oil & gas industry—either in leases or contracts. Such clauses are occasionally found in domestic contracts but almost never in domestic oil & gas leases.

160. None of the oil and gas practitioners I talked to on the telephone felt the presence of a compulsory ADR clause would cause a significant number of deals to be lost.

161. Like a pooling clause, a Pugh clause or a continuous operations clause. See *supra* part II.B.

Why aren't compulsory ADR clauses found in more domestic leases? Is it simple inertia or is there some considered business or legal reason that dissuades oil company's from putting compulsory mediation clauses in their domestic oil and gas leases and contracts?¹⁶²

VI. THE USE OF MEDIATION IN RESOLVING LESSOR/LESSEE DISPUTES

A. *Types of Lessor/Lessee Disputes*

In broadest outline the principal types of disputes which arise between lessors and lessees under an oil and gas lease are as follows: (1) surface use disputes; (2) lease termination disputes; (3) disputes involving the payment of royalties; (4) disputes involving pooling; and (5) disputes involving the implied covenants.

Surface use disputes can be quite intensive and can negatively impact the relationship between lessor and lessee, far beyond the economic impact of the dispute.¹⁶³ Surface use cases usually turn on issues such as whether the lessee's use of the surface was negligent, reasonable, in accordance with the accommodation doctrine,¹⁶⁴ related to minerals under the leased property or was in accordance with the terms of the lease, statutes, and ordinances.

The controlling legal issues in lease termination cases differ depending on whether the alleged termination occurred while the lease was in its primary or secondary term. If termination is alleged to have occurred during the primary term, the issues will likely involve either proper payment of delay rentals or the commencement of operations for drilling. If termination is alleged to have occurred during the secondary term, the controlling issues will likely focus on whether there

162. With the rapid growth of ADR in the business community many commercial contracts now contain ADR clauses. See CPR—BUSINESS DISPUTES, *supra* note 10, at 9, Exhibit D (listing a number of types of business disputes which have been successfully resolved by mediation). Two industries in which ADR is extensively used are real estate sales and securities. In the real estate sales industry disputes between agents and clients are often arbitrated or mediated. In the securities industry almost all disputes involving brokerage firms are arbitrated—not only disputes between brokers and customers but also disputes between brokerage firms and employees. See Margaret A. Jacobs, *Men's Club, Riding Crop and Slurs: How Wall Street Dealt with a Sex-Bias Case*, WALL ST. J., June 9, 1994, at A1.

163. See *supra* part IV.A.

164. Under the accommodation doctrine, if the proposed use by the mineral owner will substantially impair existing uses of the surface owner and the mineral owner has reasonable alternatives available, then the mineral owner must accommodate the surface owner's use. See *Getty Oil Co. v. Jones*, 470 S.W.2d 618 (Tex. 1971); see also *Sun Oil Co. v. Whitaker*, 483 S.W.2d. 808 (Tex. 1972); *Dunn v. Southwest Ardmore Tulip Creek Sand Unit*, 548 P.2d. 685 (Okla. Ct. App. 1976).

was production in paying quantities or whether one or more of the lease savings clauses was satisfied.¹⁶⁵

Royalty disputes typically involve the payment of royalties on gas rather than oil. There are a number of subcategories of such disputes. Most of these subcategories revolve around the following questions: How is royalty calculated? (Otherwise known as the market value-proceeds problem).¹⁶⁶ Are royalty owners entitled to share in take or pay settlements?¹⁶⁷ How do division orders effect the payment of royalties?¹⁶⁸

The controlling legal issues in disputes involving pooling typically turn on whether the pooling was done strictly in accordance with the terms of the lease pooling clause¹⁶⁹ and whether the pooling was done in good faith.¹⁷⁰

The controlling legal issues in cases involving implied covenants usually boil down to questions of whether the lessee acted as a reasonable prudent operator. The test is whether the lessee acted in good

165. See *supra* part II.B.2.a-b.

166. The market value-proceeds problem arises when gas producers enter into long term contracts with suppliers. The typical situation involves A, owner of Blackacre, who twenty years earlier executed an oil and gas lease with lessee. Lessee makes a long term contract for the sale of gas at \$0.10 per Mcf on which A's one-eighth royalty is based. Years later B, A's neighbor, executes an oil and gas lease and is able to sell his gas to the same gas producer for \$3.00 per Mcf. A, hearing of B's good fortune, promptly sues the lessee to have his royalties computed on the market value or market price of his gas (although the gas producer is only receiving \$0.10 per Mcf for A's gas). David L. Hancock, *The Gas Producer's Dilemma: Royalty Clauses and Long Term Gas Purchase Contract*, 46 U. PITT. L. REV. 517 (1985).

Texas and Oklahoma follow opposite rules on this point. See *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968). The Vela, or Texas, rule is followed in the majority of states. See, e.g., *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985). Cf. *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981). A minority of states follow the Tara or Oklahoma rule. See, e.g., *Hillard v Stephens*, 637 S.W.2d 581 (Ark. 1982).

167. A take or pay clause, contained in a gas sales contract, commits the purchaser of natural gas (generally a pipeline) to purchase, or "take," a minimum amount of natural gas from the lessee or else pay for the gas not taken. Royalties collected on such payments might represent a significant amount of revenue to the lessor. When there is a gas shortage, such a clause helps assure the pipeline that there will be adequate gas. When there is a glut of natural gas however, the pipeline may have to pay for gas that it does not take. In such times, the pipeline may offer to settle at a lower rate than originally agreed upon in lieu of breaching the contract altogether. The question arises as to what if anything the lessor is due on the settlement money for gas not taken. *James E. Prince, Production, Production, What is Production? Diamond Shamrock v. Hodel*, 1989 B.Y.U. L. REV. 1333. See also *Frey v. Amoco Prod. Co.*, 943 F.2d 578 (5th Cir. 1991); *Killman Oil v. Bruni*, 806 S.W.2d 264 (Tex. Ct. App. 1991), *writ denied*.

168. See *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981); *Gavenda v. Strata Energy, Inc.*, 705 S.W.2d 690 (Tex. 1986). See also TEX. NAT. RES. CODE ANN. § 91.401 (West 1994).

169. See, e.g., *Jones v. Killingsworth*, 403 S.W.2d 325 (Tex. 1965); *Imes v. Globe Oil & Ref. Co.*, 84 P.2d 1106 (Okla. 1938).

170. See *Imes*, 84 P.2d at 1106; *Amoco v. Underwood*, 558 S.W.2d 509 (Tex. Civ. App. 1977), *writ ref'd. n.r.e.*; *Elliott v. Davis*, 553 S.W.2d 223 (Tex. Civ. App. 1977), *writ ref'd. n.r.e.*

faith, as a competent oil man, and with due regard for the interests of the lessor.¹⁷¹

B. *Models Illustrating the Use of Mediation in Resolving Lessor/Lessee Disputes*

Within the general framework outlined above, the actual disputes that might arise under an oil and gas lease are many and varied. My main purpose in listing the types of disputes was to lay a foundation for illustrating how mediation can be used to resolve typical lessor/lessee disputes. That will be illustrated through two hypothetical examples—one, involving a surface damage dispute and the other a lease termination dispute.

1. Surface Damage Dispute

Aggressive Oil Co. has an oil and gas lease on 300 acres owned by farmer Jones. Seismic tests convinced Aggressive that Jones' farm was an excellent prospect for exploration and Aggressive began making preparations to drill a well on the property. A crew foreman went to inspect the proposed well site late one afternoon. He left after dark. Since he was in a hurry to get home, he cut across Jones' pasture to get to the main road. Along the way, he ran over Jones' prize bull.

Jones confronted the foreman, who told Jones not to worry about that bull. He said: "Old man you'll soon be making so much money off your oil royalties that you'll forget all about your stupid cattle." Jones demanded payment. The foreman said I'll tell the people at the office but, he never informed Aggressive about the accident. When Jones heard nothing relative to payment for his bull, he contacted a local lawyer, who has sent Aggressive a demand letter, in which he threatens to file suit for damages of \$50,000 as well as cancellation of the lease.

Assuming that Aggressive and Jones signed a lease similar to the one attached as Exhibit A, the lessee has a right to reasonable use of all of the surface of Jones' farm for exploration and/or production. The legal standard is negligence. The foreman was not limited by law to driving just on roads. However, as in most accident cases, factual issues abound. Was driving through the pasture negligence? Was it within the course and scope of the foreman's employment? Was the

171. See *supra* part II.D; see also *Amoco v. Alexander*, 622 S.W.2d 563 (Tex. 1981).

foreman's collision with the bull negligently caused or was it an unavoidable accident? If negligence can be shown, is it grounds for termination of the lease or is Jones limited to damages?

As a legal matter Jones' case is not an easy one on grounds of either reasonable use or negligence and it is highly unlikely that rescission of the lease would be an available remedy. On the other hand, venue lies in farmer Jones' home county and his neighbors on the jury are likely to be highly sympathetic toward the local farmer's claim against the "rich oil company" from afar.

Jones believes that Aggressive has refused to pay for his bull. Further, in his mind, their refusal to acknowledge and apologize for the accident adds insult to injury. He is a farmer and proud of it. Even if he becomes a millionaire from royalties on production from his land, he still intends to farm and raise cattle. In his mind, if royalties make his children rich that will be great, but he is too old to change his lifestyle. He feels that Aggressive has made light of his lifestyle and has been insulting and condescending. He no longer wants to do business with them. He wants them off his land and is prepared to padlock the gate. While originally he probably would have settled for \$10,000, which is slightly more than his dead bull is worth, he now wants to be rid of Aggressive and to collect the \$50,000 to "teach them a lesson."

Aggressive is flabbergasted when they receive the demand letter. They had no knowledge of the accident and barely know Jones. The Jones Lease is one of their best prospects. Further, it is a lease bearing one-eighth royalty, which has increased in value. Today leases in the area are going for royalties of one-sixth or three-sixteenths. Whether the foreman had been negligent or not, they would have been happy to pay Jones the \$10,000 his bull was worth, just to keep him happy. Today, they would probably pay double that amount. However, they are not about to stand for being padlocked out of the property and are prepared to bring legal action for injunction and for damages against Jones for obstruction. A rig has been hired and is scheduled to move to the Jones property next week. Further, they feel a demand for \$50,000 is beyond reason and fear that if word of such payment gets out other farmers in the county will try to "hold them up" for similar settlements.

Within the framework of formal legal proceedings, many of the above details and misconceptions might not come to light at all and, if they came to light, it might take a long time as the slow and arduous

legal process unfolds. By contrast, all these facts and details would likely be drawn out by a skilled mediator during the first session.

Once all the facts are on the table, it is clear that what we have is a misunderstanding that has gotten out of hand and that a simple apology from Aggressive and the foreman will go a long way toward solving the problem. In addition, Aggressive should affirm that the company respects Jones' lifestyle and property without being condescending. They may make this point by promising that their crews will be especially careful and respectful of his land and livestock and by referring to him as a partner in the well about to be drilled on his property.¹⁷² If Jones feels that Aggressive is sincere, that coupled with a generous (but not outlandish) payment for his bull might resolve the dispute. This is essentially all Jones wanted and what the Company was willing to do in the first place. Even if Aggressive has to pay a small "boot" to Jones for his aggravation (\$20,000 rather than \$10,000), such a settlement might make sense in light of the foreman's lack of judgement in dealing with the incident and Aggressive's interest in fostering future relations with Jones.¹⁷³ Further the settlement is confidential and thus limits Aggressive's exposure to other claims based on the precedent of this settlement.

Even if Aggressive feels that the facts support their position on the issues of negligence and reasonable use, they would be well advised (and most skilled mediators would so advise them if necessary) not to push for a judicial decision on these issues. First of all, they might lose before a hometown jury at the trial level and have to go through an appeal. Second, even if they win, the cost of the litigation would probably be greater than the cost of the bull. Finally, alienating Jones hurts the long term relationship and is not in Aggressive's best interest.

From Jones' standpoint, assume he has been bitten by the bug called greed, and now wants more than the \$10,000 to \$20,000 plus an apology for which he would have originally settled. He also has many incentives to compromise. He could be convinced that he might ultimately lose the case. Even if he wins a damage award at the trial level, it might not stand up on appeal. It is unlikely that he could

172. They might also show him their plans to build an access road to the proposed well-site and offer to build a cattle guard.

173. Possible areas for compromise might include not only the cash payment, but also increasing the royalty from one-eighth to one-sixth or a combination of the two. If Jones is looking for a non-monetary expression of good faith, firing the foreman who caused the problem by his lack of judgment in dealing with Mr. Jones might be an available solution.

rescind the lease and thus might have to live with a hostile lessee on his property for many years. Finally, while the case is in litigation, Aggressive might defer drilling, thus causing substantial delay in beginning the income stream from royalties on the production which Jones anticipates.

The solutions suggested above may seem simplistic. Still, they demonstrate many of the advantages of mediation—opening the channels of communication, fashioning remedies which courts cannot provide, confidentially and fostering rather than destroying long term relationships. If this matter is decided by litigation, either Jones will receive no compensation for his bull and continue to have a company he despises operating on his land, or Aggressive might be stuck with a judgment for five times the value of the bull and conceivably might even lose its lease. Litigation can only yield win/lose solutions. Mediation can create solutions where both parties win. Finally, anyone who believes that intangibles, such as an apology, are not sometimes effective in helping to resolve disputes of this kind, has little or no experience in mediation or negotiations.

2. Lease Termination Dispute

Beta Oil Company, Inc. leases a 120 acre tract of land ("Greenacre") near Giddings, Texas, from Mr. Green under an oil and gas lease which bears a one-eighth royalty. In 1984, Beta drilled a well called the Green Number One on Greenacre.¹⁷⁴ The Green Number One produced substantial quantities of oil and gas over the next several years and has long since paid out. In September, 1992, the Green Number One ceased to produce due to mechanical difficulties, but as a result of reworking over the next three months, the well resumed production in late December, 1992. Following resumption of production, the well produced at a much lower rate. Beta's records show that the well had a net operating loss for the year 1993, when depreciation

174. Assume that the Green Number One is the only production from Greenacre. The fact that the Green Number One is an Austin Chalk well is relevant to this problem. The Austin Chalk formation has limited porosity and permeability. Generally, this formation has sufficient porosity and permeability only in areas where ancient faults caused fractures. To get production, wells must intersect with these fractures. Assume the spacing is 80 acre and that a nearby well utilizing Greenacre's remaining 40 acres and adjoining land failed to intersect a fault and came in dry.

on the pump jack and other operating equipment is taken into account.¹⁷⁵ Operations for the first six months of 1994 show a net loss on a cash flow basis.

Beta began drilling horizontal wells in the Giddings (Austin Chalk) Field in 1991 and has reentered some of its older vertical wells and drilled horizontal wells with mixed but generally favorable results.¹⁷⁶ Beta has other acreage adjoining Greenacre under lease and considers the Green Number One a good prospect for a re-entry horizontal well.¹⁷⁷ A competitor, Omega Oil Co., apparently feels the same way. It has offered to lease Greenacre if Mr. Green can terminate his lease with Beta. Omega has offered Mr. Green a lease bonus of \$300 per acre and a 1/6 royalty. That offer is attractive to Mr. Green, whose royalty income from the Green Number One has declined to about one-tenth of what it once was. He has hired an attorney, who has written Beta a letter threatening to bring suit to quiet title. The letter alleges that Beta's lease on Greenacre has terminated due to a cessation of production and seeks to review Beta's financial records.

Assuming that Beta and Green signed a lease similar to the one attached as Exhibit A, the lease speaks only of "production." However, the courts read the term production to mean "production in paying quantities."¹⁷⁸

Paying quantities is defined through a two-pronged test.¹⁷⁹ First, a so called litmus or accounting test—an objective test which looks backwards—asks if operating revenues exceed operating costs over a reasonable period of time, without regard to recovery of drilling costs.¹⁸⁰ Second, a so-called reasonable prudent operator or legal

175. On a cash flow basis the well broke even for the year 1993, but lost a small amount of money during the second half of that year.

176. A horizontal well is a well that deviates from the vertical, by use of special directional drilling equipment and is drilled horizontally to penetrate a number of fractures in a formation. This method of drilling is considerably more expensive than vertical drilling but in many cases it has substantially increased production. Horizontal drilling has been particularly successful in the Giddings (Austin Chalk) and the Pearsall (Austin Chalk) fields in Texas. See B. Ray Holifield, *An Insider's View: What Really Happens in Horizontal Well Drilling*, ADVANCED OIL & GAS INSTITUTE, SOUTH TEXAS COLLEGE OF LAW (1991).

177. Generally, horizontal wells are of two types—new wells (grassroots) and re-entry wells (where existing vertical wells are reentered). *Id.* at 1.

178. See *supra* note 26.

179. See *supra* note 26.

180. The courts are not in agreement on a number of accounting issues, which are critical to this test. For example, questions arise concerning distinctions between revenues and returns of capital. See, e.g., *Pshigoda v. Texaco*, 703 S.W.2d 861 (Tex. Ct. App. 1986), *writ ref'd, n.r.e.*. Courts have also addressed whether amounts paid as royalties and overriding royalties are chargeable against revenues. See, e.g., *Cowden v. General Crude Oil*, 217 S.W.2d 109 (Tex. Civ.

test—a subjective test which looks forward—asks whether a reasonable prudent operator would continue operating the lease with a reasonable expectation of making a profit and not for mere speculation.

The party urging termination of the lease must win both prongs of the test to terminate the lease. That party also has the burden of proof. As in our example, the party urging termination will almost always be the lessor and these are not easy cases for lessors to win.¹⁸¹

The lessor must meet the first prong of the paying quantities test with evidence usually consisting of the lessee's financial books and records, which the lessor must usually obtain through subpoena and expert testimony.¹⁸² If this prong of the test shows an operating profit for the period in question, no matter how small, the case is over—summary judgment will be rendered for the lessee.

If the lessor can show an operating loss over a reasonable period of time,¹⁸³ the lessor does not necessarily win, but he can defeat a motion for summary judgment and get to the jury. To win this prong of the test the lessor must convince the jury that a reasonable and prudent operator expecting to make a profit and not merely seeking to hold the lease for speculation would not continue to operate at a loss under the circumstances.¹⁸⁴

The Beta Oil Company scenario is a classic example of a situation where the parties may have differing assessments of the law and/or the

App. 1948). They have also addressed whether depreciation and administrative expenses are deductible costs. *See, e.g.,* Bales v. Delhi-Taylor, 362 S.W.2d 388 (Tex. Civ. App. 1962), *writ ref'd, n.r.e.*; Sullivan & Garnett v. James, 308 S.W.2d 891 (Tex. Civ. App. 1957); Patton v. Rogers, 417 S.W.2d 470 (Tex. Civ. App. 1967), *writ ref'd, n.r.e.*; Ladd Petroleum Corp. v. Eagle Oil & Gas Co., 695 S.W.2d 99 (Tex. Ct. App. 1985), *writ ref'd n.r.e.*; Stewart v. Amerada Hess Corp., 604 P.2d 854 (Okla. 1979).

181. The paying quantities test is obviously heavily weighted in favor of the lessee, which makes sense in terms of policy and economics. At this point the lessee has an investment in the well, has taken the risk, and has paid all the costs. If the court is wrong the lessor will get a windfall—namely, ownership of a well capable of producing in paying quantities.

182. Like the courts, experts often disagree as to what revenues and expenses must be taken into account and what constitutes a reasonable period of time.

183. Operating costs must exceed operating revenues over a reasonable period of time. As with the other elements of the litmus test what constitutes a reasonable time for unprofitability is not clear. *See* Clifton v. Koontz, 325 S.W.2d 684, 691 (Tex. 1959) (indicating that there is no bright line fixed period and that a relatively long period is necessary to give a true financial picture). *But see* Sullivan & Garnett, 308 S.W.2d at 891 (discussing a period of only six months). Many lawyers counsel in terms of at least a year to allow for fluctuations and booking of particular expenses and revenues, but there is no judicial holding to that effect.

184. *See, e.g.,* Bell v. Mitchell Energy, 553 S.W.2d 626 (Tex. Civ. App. 1977), *no writ*; Barby v. Singer, 648 P.2d 14 (Okla. 1982). The factors taken into account in making this factual determination include the following: (1) the extent of the losses—small or large; (2) impending shortages—likelihood of price increases; (3) geological potential—possibilities of reworks, deeper formations or secondary recovery procedures; (4) the possibility, suggested in the example, of replacing the vertical well with a horizontal well.

facts and where a mediator might facilitate a resolution of the dispute by helping the parties to better assess the strengths and weaknesses of their respective positions. The mediator might begin by convincing the lessor that his burden in this type of case is hard to meet. Factual as well as legal doubts are typically resolved in favor of the lessee because policy, economics, and equities are all on the side of the lessee in this type of dispute.

This is not the type of case that courts are particularly well equipped to decide. While courts are well equipped to impartially resolve disputes by weighing the facts and applying the law, and by applying appropriate procedures and rules of evidence, they are not necessarily knowledgeable in areas of finance, accounting and business planning. Furthermore, courts are only able to grant certain remedies, such as award money damages, issue injunctions, or decree specific performance. In disputes such as the Beta Oil Company scenario, forward looking business solutions, which are beyond a court's power to provide, are more appropriate.¹⁸⁵ Accordingly, many of the matters heretofore discussed might come into play in this case. The parties have a continuing relationship that has extended over a period of ten years. The quality of that relationship will bear significantly on the parties' ability to resolve this dispute.¹⁸⁶ The parties will likely want to retain control over the matter and work toward a forward looking business solution.¹⁸⁷

There are certain concessions the lessee may be convinced to make. Its willingness to make concessions will depend on the strength of the lessor's case. For example, assume that the lessee's books and records show that over the past year the Green Number One operated at a modest loss. This means the lessor could get past a motion for summary judgement and get to the jury. While from the facts given it appears the lessee has a strong case under the second prong of the paying quantities test,¹⁸⁸ it is impossible to predict jury verdicts with any degree of certainty. If these are the facts, in order to hold the lease the lessee might be convinced to raise the royalty from one-

185. See CPR—OIL AND GAS, *supra* note 12, at 3-5.

186. Does Green feel Beta has been a good operator? If so, he may prefer to stick with Beta rather than begin a relationship with a new operator. Here the nature and history of the 10 year relationship will have a big impact on the parties' ability to settle. The more satisfactory that relationship has been, the less inclined the lessor will be to want to terminate the lease.

187. See *supra* part IV.C-D.

188. Subjective, good faith expectations of future profits are the key. Evidence pertaining to horizontal drilling plans and the desire of Beta's competitor Omega appears quite strong.

eighth to one-sixth and to offer Green a firm commitment to drill a horizontal well within a stated time period.

On the other hand, if Beta's books show that it made an operating profit, though a small one, over the period in question, Beta may be less inclined to grant concessions. However, even in that case, since it already intends to drill a horizontal well on the property, a firm commitment to do so by a date certain may be offered by way of compromise. Under these facts the mediator's best approach might be to convince Green that he has little likelihood of surviving a motion for summary judgment. The main point illustrated by this problem is that mediation helps the parties to evaluate the strengths and weakness of their cases and that forward looking solutions, which may be win/win situations for both sides from a business standpoint, can surface when the parties retain control over the resolution to their dispute.

VII. COMPULSORY MEDIATION CLAUSE

A. *A Suggested Form of Clause*

The following is a form of compulsory mediation clause, which calls for good faith mediation prior to institution of litigation:

Prior to instituting litigation, the parties will attempt in good faith to resolve any controversy or claim arising out of, in connection with or relating to this lease by mediation. Such mediation will be conducted by a mediator chosen by agreement of the parties or duly appointed by the American Arbitration Association in accordance with the Commercial Mediation Rules of such association then in effect. The cost of mediation shall be shared equally by the lessor and lessee. If the matter has not been resolved pursuant to the aforesaid mediation procedure within sixty days of the commencement of such procedure (which period may be extended by mutual agreement), either party may initiate litigation.

The clause could be modified or refined in a number of ways. Other possibilities include a three-step clause calling for negotiation, mediation and then binding arbitration. Specific clauses range from simple "negotiate-in-good-faith" clauses to elaborate systems providing for mediation, mini-trial or expert fact-finding, sometimes in conjunction with binding arbitration or other adjudicative procedures.¹⁸⁹

189. See CPR—DISPUTE RESOLUTION CLAUSES, *supra* note 134. CPR sets forth the form of a number of clauses which can be used in various combinations. It recommends that in drafting a specific clause for a specific agreement the parties consider including provisions that reflect the three successive stages of resolution of business disputes—negotiation (a provision requiring

B. *Administrative Support Structure*

The above clause names the American Arbitration Association ("AAA") as the organization to appoint the mediator and to administer the mediation process.¹⁹⁰ The mention of the AAA was included to illustrate that in addition to a mediation clause and mediators, an administrative support structure is also required for the mediation process to function.¹⁹¹ In other words, there must be an organization which maintains a database of qualified mediators, establishes standards and procedures, monitors conflicts of interests, appoints mediators, administers the process, and monitors results and performances.¹⁹² Two possibilities exist relative to a support structure in connection with mandatory ADR clauses in oil and gas leases. One is, of course, to name AAA, JAMS, CPR or some similar existing organization, with an infrastructure in place as the administrative organization. The other alternative would be for the oil and gas industry to develop its own organization for appointing mediators and administering its cases.¹⁹³ Today, there are a number of national, regional and local organizations which provide support services for ADR.

C. *Enforcement of Dispute Resolution Clauses*

Unlike arbitration clauses, which are specifically made enforceable by federal¹⁹⁴ and state statutes,¹⁹⁵ enforcement of nonarbitral ADR clauses generally has not been addressed by statute. Thus, it is not certain whether a clause calling for non-binding mediation prior to

negotiations between executives with decision-making authority); non-binding resolution (a provision requiring some form of non-binding dispute resolution, such as mediation) and binding resolution (an adjudication procedure, such as binding arbitration). The various parts can be put together in any combination that suits the parties' needs.

190. The American Arbitration Association ("AAA"), a not-for-profit organization, is the oldest and by far the largest of ADR providers, having handled approximately 64,000 cases last year. There are numerous other ADR providers, both for-profit and not-for-profit. The two largest for-profit ADR providers, Judicial Arbitration and Mediation Services ("JAMS"), an organization whose mediators and arbitrators consist of retired judges, and Endispute recently merged. Together, these two organizations handled about 17,000 cases last year. See *BUSINESS LAW TODAY*, Sept.-Oct. 1994, at 44.

191. Mediators alone are no more able to provide all of the necessary turn-key services needed to resolve disputes than are judges alone able, without the supporting court systems, to perform the entire judicial function.

192. See CPR—BUSINESS DISPUTES, *supra* note 10, at 22.

193. Some industries support the mediation process via extensive "in-house" or "industry supported" dispute resolution mechanisms, which maintain lists of qualified mediators. Examples include real estate trade associations and securities self regulatory organizations such as the New York Stock Exchange and the National Association of Securities Dealers.

194. 9 U.S.C. § 1 (1994).

195. TEX. CIV. PRAC. & REM. CODE ANN. §§ 154.001-073 (West Supp. 1995); OKLA. STAT. ANN. tit. 15, §§ 801-18 (West 1993 & Supp. 1995).

institution of litigation is enforceable. Although several lower courts have enforced agreements to mediate future disputes, the case law on this issue is sparse.

Some commentators have argued against enforceability, basing their arguments on the voluntary nature of the mediation process and the difficulty of fashioning an appropriate remedy.¹⁹⁶ Unlike binding arbitration, mediation offers no certainty that the dispute will be resolved. Thus some have argued that an agreement to mediate is nothing more than an agreement to try in good faith to resolve a dispute. They reason that if one party is determined not to settle, nothing is gained by forcing that party to mediate. Under this line of reasoning, when one party breaches an agreement to mediate by instituting litigation, the other party's position is not worsened in a way that can be redressed by measurable damages or specific performance because the breach merely results in the same litigation that would have occurred absent the breach. That argument is buttressed by the maxim that equity will not compel a futile or ineffective act.

Paradoxically, however, this line of reasoning, which purports to be rooted in the nature of the process, rests on a fundamental misconception about the process. When one understands the mediation process and adopts a process-oriented definition of mediation these arguments are effectively countered.¹⁹⁷ Mediation is a process which facilitates settlement. It is not a process that guarantees settlement in all cases. To the contrary, the mediation process generally assumes that at the onset the parties are unwilling to settle. Because one or both parties do not want to settle, does not mean settlement will not occur. It logically follows from this process-oriented definition that a court can enforce a compulsory ADR clause in the same manner in which courts enforce contracts generally.¹⁹⁸ In the event of breach, the court can fashion an appropriate remedy—either damages or specific performance.

Existing authority, though sparse, supports the proposition that compulsory mediation clauses are enforceable by the courts. In Texas, both by statute¹⁹⁹ and under the case law,²⁰⁰ a court may on its own

196. See generally Welch, *supra* note 61, at 128-132.

197. Lucy V. Katz, *Enforcing An ADR Clause—Are Good Intentions All You Have?*, 26 AM. BUS. L.J. 575 (1988).

198. Enforcement means enforcing the parties' agreement to participate in good faith in a settlement process, not imposing a settlement.

199. TEX. CIV. PRAC. & REM. CODE ANN. § 154.021 (West Supp. 1995).

200. Decker v. Lindsay, 824 S.W.2d 247 (Tex Ct. App. 1992).

motion order mediation. The *Decker* case was an action for mandamus where a relator sought to have the Court of Appeals instruct the trial judge to lift her order ordering the parties to mediate.²⁰¹ The Court of Appeals held that, even though one or both of the parties believe the dispute to be unresolvable except by litigation, the trial court may nevertheless order mediation on its own motion.²⁰²

Ultimately, questions regarding the enforceability of agreements to mediate are of more academic than practical interest. Although agreements to mediate are probably enforceable, it is unlikely that a party would sue to enforce such an agreement, except under unusual circumstances. As discussed herein, settlement of disputes through negotiation, either assisted by third parties or not, is a voluntary process. Courts cannot force the parties to settle their disputes. At most it can force them to try. If the parties meet and discuss their differences, the good faith standard would probably be met, even though neither party moves from its original position. In practice, a finding of bad faith would probably require showing complete refusal to negotiate²⁰³ or something like a "smoking gun" memo clearly indicating bad faith.²⁰⁴

VIII. SUMMARY AND CONCLUSION

Despite the fact that most disputes between lessors and lessees lend themselves to resolution through mediation,²⁰⁵ the oil and gas industry has been slow to embrace mediation as a means for resolving such disputes.²⁰⁶ The reason is not apparent to this writer, but the best evidence points to simple inertia. It is time for oilmen and their attorneys to take another look at their lease forms²⁰⁷ and remind themselves that the oil and gas lease became what it is today through evolution responsive to the needs of the industry. In addition, they should develop a familiarity with and an understanding of the ADR

201. *Id.*

202. *Id.*

203. Examples include refusal to meet, refusal to abide by the rules, refusal to make an opening statement, or leaving before the mediator declares an impasse.

204. For example, statements to the effect that "I will sit there if they make me but I will not settle under any circumstances, nor will I listen to a word the other party says."

205. See *supra* Part IV.

206. See CPR—OIL AND GAS, *supra* note 12.

207. Although outside the scope of this paper, the same principle applies to contracts used in the oil and gas industry, not just leases. An ADR clause may also be appropriate for farmout agreements, joint operating agreements and numerous other types of agreements used in the industry. CPR—OIL & GAS, *supra* note 12, at 2-5.

process, which in the 1980s and 1990s has emerged as a powerful tool for resolving business related disputes.

This reevaluation should lead to the inevitable conclusion that it is time for the oil and gas lease to evolve a little more—namely be changed to add a compulsory ADR clause.²⁰⁸ Such a clause will not resolve each and every dispute between lessors and lessees, but it probably will keep many such disputes from reaching the courthouse. It will also enable the parties to retain greater control over resolution of their disputes, to devise solutions that make sense from a business as well as a legal perspective, and to structure settlements in ways courts cannot. Appropriate use of ADR procedures will also result in savings of time and money and will help foster the relationship between lessors and lessees.

ADR and the oil and gas lease—it's a marriage made in heaven and it's time for it to happen.

208. The clause suggested above is minimal, the intention being a generic example. Clearly, there are any number of ways the clause could be improved or adapted to fit specific situations.

OIL, GAS AND MINERAL LEASE

This Agreement made this _____ day of _____, 19____, between _____ and _____
(Lessor) (whether one or more) whose address is _____
Witnesseth:

1. Lessor in consideration of _____ Dollars (\$ _____), in had paid, of the royalties herein provided, and of the agreement of Lessee herein contained, hereby grants, leases and lets <exclusively> unto Lessee for the purpose of investigating <exploring>, prospecting, drilling and mining for and producing oil, gas and <all other minerals>, laying pipe lines, building roads, tanks, power stations, telephone lines and other structures thereon and on, over and across lands owned or claimed by Lessor adjacent and contiguous thereto, to produce, save, take care of, treat, transport, and own said products and housing its employees, the following described land in _____ County, Texas, to-wit:

This lease also covers and includes all land owned or claimed by Lessor adjacent or contiguous to the land particularly described above, whether the same be in said survey or surveys or in adjacent surveys, although not included within the boundaries of the land particularly described above. For the purpose of calculating the rental payments hereinafter provided for, said land is estimated to comprise _____ acres, whether it actually comprises more or less.

2. Subject to the other provisions herein contained, this lease shall be for a term of _____ years from this date (called "primary term") and <as long thereafter> as oil, gas or other mineral is produced from said land or land with which said land is pooled hereunder.

3. The royalties to be paid by Lessee are: (a) on oil, one-eighth of the produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected; Lessee may from time to time purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase; (b) on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or for the extraction of gasoline or other product therefrom, the <market value> at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the <amount realized> from such sale;

Anniversary date of lease

Granting clause

Includes right to conduct seismic

Other minerals problem

Legal description-usually describes 100% of leased property even though lessor owns less than 100%.

Mother Hubbard or coverall clause

Habendum clause
Primary & secondary term.Royalty clause
Oil royaltyGas royalty
Market value/amount realized

APPENDIX A

while there is a gas well on this lease or on acreage pooled therewith, but gas is not being sold or used, Lessee may pay as royalty, on or before ninety (90) days after the date on which said well is shut in and thereafter at monthly intervals, a sum equal to one-twelfth (1/12) of the amount of the annual rental payable in lieu of drilling operations during the primary term of the number of acres subject to this lease at the time such payment is made, and if such payment is made or tendered, this lease shall not terminate and it will be considered that gas is being produced from this lease in paying quantities.

4. Lessee, at its option, is hereby given the right and power to pool or combine the acreage covered by this lease, or any portion thereof as to oil and gas, or either of them, with other land, lease or leases in the immediate vicinity thereof to the extent hereinafter stipulated, when in Lessee's judgment it is necessary or advisable to do so in order properly to explore, or to develop and operate said leased premises in compliance with the space rules of the Railroad Commission of Texas, or other lawful authority, or when to do so would, in the judgment of Lessee, promote the conservation of oil and gas in and under and that may be produced from said premises. Units pooled for oil hereunder shall not substantially exceed 40 acres each in area, and units pooled for gas hereunder shall not substantially exceed in area 640 acres each plus a tolerance of 10% thereof, provided that should governmental as above provided as to oil in any one or more strata and as to gas in any one or more strata. The units formed by pooling as to any stratum or strata need not conform in size or area with the unit or units into which the lease is pooled or combined as to any other stratum or strata, and oil units need not conform as to the area with gas units. The pooling in one or more instances shall not exhaust the rights of the Lessee hereunder to pool this lease or portions thereof into other units Lessee shall file for record in the appropriate records of the county in which the leased premises are situated an instrument describing and designating the pooled acreage as a pooled unit. Lessee may at its election exercise its pooling option after commencing operations for or completing an oil or gas well on the leased premises, and the pooled unit may include, but it is not required to include, land or leases upon which a well capable of producing oil or gas in paying quantities has theretofore been completed or upon which operations for the drilling of a well for oil or gas have theretofore been commenced. Operations for drilling on or production of oil or gas from any part of the pooled unit which includes all or a portion of the land covered by this lease regardless of whether such operations for drilling were commenced or such production was secured before or after the execution of this instrument or the instrument designating the pooled unit, shall be considered as operations for drilling on or production of oil and gas from land covered by this lease whether or not the well or wells be located on the premises covered by this lease, and the entire acreage constituting such unit or units, as to oil and gas, or either of them, as herein provided, shall be treated for all purposes, except the payment of royalties on production from the pooled unit, as if the same were included in this lease. For the purpose of computing the royalties to which owners of royalties and payments out of production and each of them, shall be entitled on production of oil and gas, or either of them, from the pooled unit, there shall be allocated to the land covered by this lease and

Shut in gas royalty

Pooling clause.

Procedure for pooling

Exercised in good faith

Limits on size of unit.

Designation of unit filed in county

Note: no Pugh clause to protect lessor.

Effect of pooling Modifies Habendum Clause Modifies Royalty Clause

included in said unit a pro rata portion of the oil and gas, or either of them, produced from the pooled unit after deducting that used for operations on the pooled unit. Such allocation shall be on <acreages basis> --that is to say, there shall be allocated to the acreage covered by this lease and included in the pooled unit that pro rata portion of the oil and gas, or either of them, produced from the pooled unit which the number of surface acres covered by this lease and included in the pooled unit bears to the total number of surface acres included in the pooled unit. Royalties hereunder shall be computed on the portion of such production, whether it be oil and gas, or either of them, so allocated to the land covered by this lease and included in the unit just as though such production were from such land. The production from an oil well will be considered as production from the lease or oil pooled unit from which it is producing and not as production from a gas pooled unit; and production from a gas well will be considered as production from the lease or gas pool unit from which it is producing and not from an oil pooled unit.

5. If <operations for drilling are not commenced> on said land or on acreage pooled therewith as above provided on or before one year from this date, the lease shall then terminate as to both parties, <unless> on or before such anniversary date Lessee shall pay or tender to Lessor or to the credit of Lessor in _____ Bank at _____, Texas, (which bank and its successors are Lessor's agent and shall continue as the depository for all rentals payable hereunder regardless of changes in ownership of said land or the rentals) the sum of _____ Dollars (\$ _____), (herein called rentals), which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months. In like manner and upon like payments or tenders annually, the commencement of drilling operations may be further deferred for successive periods of twelve (12) months each <during the primary term.> The payment or tender of rental under this paragraph and of royalty under paragraph 3 on any gas well from which gas is not being sold or used may be made by the check or draft of Lessee <mailed or delivered> to the parties entitled thereto or to said bank on or before the date of payment. If such bank (or any successor bank) should fail, liquidate or be succeeded by another bank, or for any reason fail or refuse to accept rental, Lessee shall not be held in default for failure to make such payment or tender of rental until thirty (30) days after Lessor shall deliver to Lessee a proper recordable instrument, naming another bank as agent to receive such payments or tenders. The down cash payment is consideration for this lease according to its terms and shall not be allocated as a mere rental for a period. Lessee may at any time or times execute and deliver to Lessor or to the depository above named or place of record a release or releases covering any portion or portions of the above described premises and thereby surrender this lease as to such portion or portions and be relieved of all obligations as to the acreage surrendered, and thereafter the rentals payable hereunder shall be reduced in the proportion that the acreage covered hereby is reduced by said release or releases.

6. If prior to discovery and production of oil, gas or other mineral on said land or on acreage pooled therewith Lessee should drill a <dry hole> or holes thereon, or [if after discovery and production of oil, gas or

Pooling on acreage basis.

Drilling and Delay Rental Clause

what is "commenced".

"unless" form of delay rental clause.

Depository bank procedure.

Delay rentals can be paid only during primary term. If mailed, post office error does not terminate lease.

surrender clause

Operations clause

dry hole clause**cessation of production clause****continuous operations clause****express clause re: protection against drainage.****Surface use clause****Notice of assignment clause**

or other mineral, the production thereof should cease from any cause,] this lease shall not terminate if Lessee <commences operations for drilling> or reworking within sixty (60) days thereafter or if it be within the primary term, commences or resumes the payment or tender of rentals or commences operations for drilling or reworking on or before the rental paying day next ensuing after the expiration of sixty (60) days from the date of completion of dry hole or cessation of production. If any time subsequent to sixty (60) days prior to the beginning of the last year of the primary term and prior to the discovery of oil, gas or other mineral on said land, or on acreage pooled therewith, Lessee should drill a dry hole thereon, no rental payment or operations are necessary in order to keep the lease in force during the remainder of the primary term. If at the expiration of the primary term, oil, gas or other mineral is not being produced on said land, or on acreage pooled therewith, but Lessee is then engaged in drilling or reworking operations thereon or shall have completed a dry hole thereon within sixty (60) days prior to the end of the primary term, the lease shall remain in force so long as operations on said well or for drilling or reworking of any additional well are prosecuted with no cessation of more than sixty (60) consecutive days, and if they result in the production of oil, gas or other mineral, so long thereafter² as oil, gas or other mineral is produced from said land or acreage pooled therewith. Any pooled unit designated by Lessee in accordance with the terms hereof, may be dissolved by Lessee by instrument filed for record in the appropriate records of the county in which the leased premises are situated at any time after the completion of a dry hole or the cessation of production on said unit. In the event a well or wells producing oil or gas in paying quantities should be brought in on adjacent land and within three hundred thirty (330) feet of and draining the leased premises, or acreage pooled therewith, Lessee agrees to drill such offset wells as a <reasonable prudent operator> would drill under the same or similar circumstances.

7. Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by Lessee on said land, including the right to draw and remove all casing. When required by Lessor, Lessee will bury all pipelines below ordinary plow depth, and no well shall be drilled within two hundred (200) feet of any residence or barn now on said land without Lessor's consent.

8. The rights of either party hereunder may be assigned in whole or in part, and the provisions hereof shall extend to their heirs, successors and assigns; but no change or division in ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligations or diminish the rights of Lessee; and no change or division in such ownership shall be binding on Lessee until thirty (30) days after Lessee shall have been furnished by registered U. S. mail at Lessee's principal place of business with a certified copy of recorded instrument or instruments evidencing same. In the event of assignment hereof in whole or in part, liability or breach of any obligation hereunder shall rest exclusively upon the owner of this lease or of a portion thereof who commits such breach. In the event of the death of any person entitled to rentals hereunder, Lessee may pay or tender such rentals to the credit of the deceased or the estate of the deceased until such time as Lessee is furnished with proper evidence of the appointment and qualification of an executor or administrator of the

estate, or if there be none, then until Lessee is furnished with evidence satisfactory to it as to the heirs or devisees of the deceased and that all debts of the estate have been paid. If at any time two or more persons be entitled to participate in the rental payable hereunder, Lessee may pay or tender said rental jointly to such persons or to their joint credit in the depository named herein; or, at Lessee's election, the proportionate part of said rentals to which each participant is entitled may be paid or tendered to him separately or to his separate credit in said depository; in payment or tender to any participant of his portion of the rentals hereunder shall maintain this lease as to such participant. In event of assignment of this lease as to a segregated portion of said land, the rentals payable hereunder shall be apportionable as between the several lease hold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other lease hold owners hereunder.

9. The breach by Lessee of any obligation arising hereunder shall not work a forfeiture or termination of this lease nor cause a termination or reversion of the estate created hereby nor be grounds for cancellation hereof in whole or in part. In the event Lessor considers that operations are not at any time being conducted in compliance with this lease, Lessor shall notify Lessee in writing of the facts relied upon as constituting a breach hereof, and Lessee, if in default, shall have sixty (60) days after receipt of such notice in which to commence the compliance with obligations imposed by virtue of this instrument. After the discovery of oil, gas or other mineral in paying quantities on said premises, Lessee shall develop the acreage retained hereunder as a ~~reasonably prudent operator~~ but in discharging this obligation it shall in no event be required to drill more than one well per forty (40) acres of the area retained hereunder and capable of producing oil in paying quantities and one well per 640 acres plus an acreage tolerance not to exceed 10% of 640 acres of the area retained hereunder incapable of producing gas or other mineral in paying quantities.

10. Lessor hereby warrants and agrees to defend the title to said land and agrees that Lessee at its option may discharge any tax, mortgage or other lien upon said land, either in whole or in part, and in event Lessee does so, it shall be subrogated to such lien with right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same. Without impairment of Lessee's rights under the warranty in event of failure of title, it is agreed that if Lessor owns an interest in the oil, gas or other minerals on, in or under said land less than the entire fee simple estate, whether or not this lease purports to cover the whole or a fractional interest, then the royalties and rentals to be paid Lessor shall be reduced in the proportion that his interest bears to the whole and undivided fee and in accordance with the nature of the estate of which Lessor is seized. Should any one or more of the parties named above as Lessors fail to execute this lease, it shall nevertheless be binding upon the party or parties executing the same. Failure of Lessee to reduce rental paid hereunder shall no impair the right of Lessee to reduce royalties.

Delay rentals are apportioned, but royalties are not apportioned in post-lease conveyance situation.

Notice of Forfeiture clause. Applies to breaches of implied covenants and failure to pay royalties. Does not apply to failure to pay delay rentals.

express clause re: implied covenant to develop.

Warranty clause & Subrogation clause

Proportionate Reduction clause modifies granting clause

Force Majeure Clause

11. Should Lessee be prevented from complying with any express or implied covenant of this lease, from conducting drilling or reworking operations thereon or from producing oil or gas therefrom by reason of scarcity of or inability to obtain or to use equipment or material, or by operation of force majeure, any Federal or state law or any order, rule or regulation of governmental authority, then while so prevented, Lessee's obligation to comply with such covenant shall be suspended, and Lessee shall not be liable in damages for failure to comply therewith; and this lease shall be extended while and so long as Lessee is prevented by any such cause from conducting drilling or reworking operations on or from producing oil or gas from the leased premises; and the time while Lessee is so prevented shall not be counted against Lessee, anything in this lease to the contrary notwithstanding.

In Witness Whereof, this instrument is executed on the date first above written:

Witnesses:

Lessor

APPENDIX B

Dated December 30, 1857
Deed Book P, p. 357
\$1 in hand.

Pennsylvania Rock Oil Company
to

E. B. Bowditch and E. L. Drake

'Demise and let' all the lands owned or held under lease by said company in the County of Vanango, State of Pennsylvania, 'To bore, dig, mine, search for and obtain oil, salt water, coal and all materials existing in and upon said lands, and take, remove and sell such, etc., for their own exclusive use and benefit, for the term of 15 years, with the privilege of renewal for same term. Rental, one-eighth of all oil as collected from the springs in barrels furnished or paid for by lessees. Lessees may elect to purchase said one-eighth at 45 cents per gallon, but such election, when made, shall remain fixed. On all other minerals, 10 per cent of the net profits. Lessees agree to prosecute operations as early in the spring of 1858 as the season will permit, and if they fail to work the property for an unreasonable length of time, or fail to pay rent for more than 60 days, the lease to be null and void.'

By agreement dated February 12, 1858, and recorded in Deed Book P, p. 441, the above lease is amended so that 12 cents for every gallon of oil shall be in full of all other rental; also giving lessees the privilege of renewal for 25 years.